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VOL. 3113

No. 16,483 ✓

IN THE

**United States Court of Appeals
For the Ninth Circuit**

— See AB80 3112 ✓

DR. ROBERT L. HARGRAVE,

Appellant,

vs.

E. G. WELLMAN, doing business as
Wellman Enterprises,

Appellee.

**Appeal from the United States District Court
for the District of Montana.**

BRIEF OF THE APPELLANT.

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FILED

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PAUL P. O'BRIEN, CLERK

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No. 16,483

IN THE

**United States Court of Appeals
For the Ninth Circuit**

DR. ROBERT L. HARGRAVE,

Appellant,

VS.

E. G. WELLMAN, doing business as
Wellman Enterprises,

Appellee.

**Appeal from the United States District Court
for the District of Montana.**

BRIEF OF THE APPELLANT.

STATEMENT OF THE CASE.

This is an action to recover damages for personal injuries arising out of a horseback ride in Glacier National Park, Montana. The action was commenced in the United States District Court at Great Falls, Montana, by Robert L. Hargrave, M.D. of Wichita Falls, Texas. It was brought against E. G. Wellman operating a business in Glacier National Park under the name of "Wellman Enterprises". Mr. Wellman's business consisted of renting pack and saddle horses to tourists in the Glacier National Park.

Hargrave, plaintiff below, rented a horse from the Wellman Enterprises at Many Glaciers Hotel which was located in the National Park. The purpose of such rental was to ride to a scenic point known as "Lake Josephine" to take colored pictures (Tr. p. 86). Hargrave was accompanied by his 15 year old daughter and the party was led by a guide, Dillon, who was an employee of the Wellman Enterprises. The trip to Lake Josephine was uneventful. On the return to the hotel, the guide Dillon suddenly and without warning spurred his horse down the trail at a rapid gait. This sudden movement by the lead horse ridden by the guide caused the horse upon which Hargrave was riding to suddenly lunge forward and begin to run. The sudden jolting and bumping of his mount caused extreme trauma to Hargrave's back, resulting in compression fracture of the 12th dorsal vertebra. This injury to the plaintiff Hargrave resulted in permanent damage and interference with his ability to practice medicine and surgery.

Prior to the ride, Hargrave, Plaintiff below, received no instructions nor warning of the propensity of his horse to bolt or run upon the movement of other horses. It is the theory of the Appellant, Plaintiff below, that the guide Dillon knew of the propensity of this horse and was negligent in galloping his horse, when he knew or should have known that the horse upon which Hargrave was riding would immediately bolt and gallop.

Trial was had to a jury in this cause. Following erroneous oral and written charges, the jury returned a

verdict for the Defendant, Appellee herein. From such verdict and resulting judgment, this appeal has been duly perfected.

STATEMENT OF THE PLEADINGS.

By agreement of counsel, it was stipulated that Plaintiff's case should proceed on the sole theory of negligence of the Defendant's guide Dillon, who Plaintiff alleged suddenly galloped his mount without warning, thus causing Plaintiff's mount to bolt, gallop and run suddenly, resulting in serious and severe injuries to Plaintiff.

Plaintiff did not waive his written request, made before trial, to amend his complaint under and by virtue of Federal Rule 15(b). In this request he alleged as an additional count of negligence that the Defendant's guide failed to warn Plaintiff as to the traits of Plaintiff's mount respecting the fact that it would follow and perform in the same manner and gait as the Defendant's guide's mount would do.

COURT'S JURISDICTION.

The Honorable District Court had jurisdiction of this case in that there was a diversity of citizenship between the parties and the amount in controversy exceeded the sum of \$3,000.00 (Title 28, U.S. Code, Sections 1332 and 1391).

This appeal has been duly and timely filed by Appellant as a result of the errors committed by the Trial Court, first in failing to allow Appellant to

amend his complaint, as provided by Federal Rule 15(b); second, due to the Trial Court's erroneous instruction to the jury on the doctrine of assumption of risk; third, the refusal of the Trial Court to submit written instructions, timely requested by Appellant on the issues of bailment, common carrier and implied warranty.

POINTS OF ERROR.

POINT ONE.

The Court erred in instructing the jury on assumption of risk (Tr. p. 320), when such doctrine was not applicable. Assumption of risk is an affirmative defense and must be proven by the Defendant. The record is devoid of evidence that Appellant had any knowledge of the propensity of his mount to gallop or run, he having hired a horse to walk only along a short mountain trail.

POINT TWO.

The Court erred in failing to submit to the jury a timely written instruction offered by Appellant on hiring of animals as a bailment and that a bailor of animals has a duty to inform a bailee respecting habits, traits or propensities of such animals.

POINT THREE.

The Court erred in failing to submit to the jury a timely written instruction relative to the duty of a common carrier to exercise the utmost care and dili-

gence on behalf of persons carried for hire, it being undisputed that the Appellee was a person engaged in carrying persons from place to place in Glacier National Park for hire or reward.

POINT FOUR.

The Court erred in failing to submit the written instructions, which were timely submitted, relative to the law pertaining to invitees, in that the undisputed evidence raised such instructions and issues.

POINT FIVE.

The Court erred in failing to instruct the jury relative to the law of implied warranty in bailment contracts. Appellant submitted timely written instructions on this point and the Court failing to give same, the jury was prevented from considering this legal position taken by Appellant which might have allowed the jury to find a breach of implied warranty on the part of the Appellee.

POINT SIX.

The Court erred in failing to submit written instructions and issues, which were timely submitted, relative to the application of the law of contributory negligence, as defined and tendered by the Plaintiff.

POINT SEVEN.

The Court erred in failing to allow Appellant to amend his complaint (Tr. p. 16), as provided by Rule 15(b), so that Appellant could urge, as an additional count of negligence, that Appellee's guide had failed to instruct Appellant as to the trait of his mount in that it would follow and perform in the same gait which the leading mount would do.

**STATEMENT AND ARGUMENT
REGARDING POINT ONE.**

Appellant maintains that the District Court erred in instructing the jury on assumption of risk because at no place in the record is there any evidence which would support an instruction to the jury regarding this doctrine.

It is a well established common law that knowledge and appreciation of the danger is an essential element of the defense of assumption of risk. To make a case of assumption of risk, it is not enough that the injured party know of the thing from which harm might come; he must know and appreciate the danger from which he suffered.

The doctrine of assumed risk does not apply unless the particular condition of peril has continued long enough so that the person alleged to have assumed the risk can be found to have known or have been charged with knowledge of the dangers. The doctrine of assumed risk is based upon voluntary exposure to danger and is applicable only in cases where the in-

jured person might reasonably elect whether or not he should expose himself to peril. 38 *Amer. Juris.*, p. 845. *Alexander v. Great Northern Railroad*, 51 Mont. 565, 154 Pac. 914; *Westlake v. Keating G. Min. Co.*, 48 Mont. 120, 136 Pac. 38; *Osterhold v. Boston & Mont. etc. Co.*, 40 Mont. 508, 107 Pac. 499; *O'Brien v. Corra-Rock Island Min. Co.*, 40 Mont. 212, 105 Pac. 724; *McCabe v. Montana C. Ry. Co.*, 30 Mont. 323, 76 Pac. 701.

Knowledge of the risk is the watchword of assumption of risk. 59 *Cinn. N. O. & T. P. R. Co. v. Thompson* (6th CCA 1916) 236 Fed. 9. Ordinarily the plaintiff will not be taken to assume any risk of conditions or activities of which he is ignorant. *Shanney v. Boston Madison Square Garden Corp.*, 1936, 296 Mass. 168, 5 N.E. 2d 1; *Dahna v. Fun House Co.*, 1927, 204 Iowa 922, 216 N.W. 262; *Tantillo v. Goldstein Bros. Amusement Co.*, 1928, 248 N. Y. 286, 162 N.E. 82; *Baltimore & O. S. W. R. Co. v. Carroll*, 1928, 200 Ind. 589, 163 N.E. 99. Further, he must not only know of the facts which create the danger, but he must comprehend and appreciate the danger itself. *Choctaw O. & G. R. Co. v. Jones*, 1906, 77 Ark. 367, 92 S.W. 244, 4 L.R.A. N.S. 837 & Ann. Cas. 430; *Chapin's Cas. Torts*, 2d Ed. 300; *Fitzgerald v. Connecticut River Paper Co.*, 1891, 155 Mass. 155, 29 N.E. 464, 31 Am. St. Rep. 537; *Zurich General Accident & Liability Ins. Co. v. Childs Co.*, 1930, 253 N. Y. 324, 171 N.E. 391; *Federal Compress & Warehouse Co. v. Harmon*, 1938, 196 Ark. 417, 118 S.W. 2d 239. If, because of lack of information, he does not comprehend the risk involved in a

known situation, he will not be taken as to assume such risk. His failure to exercise ordinary care to discover the danger is not properly a matter of assumption of risk, but the defense of contributory negligence.

The record in this case is void of evidence to show that the Appellant, Robert L. Hargrave, had any knowledge that the horse upon which he was mounted would suddenly bolt and run and/or gallop along the trail in the park.

Appellant testified that he rented his mount along with his daughter's mount, for the purpose of riding up to Lake Josephine and return. Further, he testified that he was not an experienced rider (Tr. p. 80), nor acquainted with the traits of saddle horses.

The record being void of evidence that Appellant had knowledge that his mount might commence to gallop, run or canter, it was improper for the District Judge to instruct the jury on assumption of risk, as Appellee, Defendant below, failed to discharge his burden proving knowledge of the risk on the part of the Appellant, which would have made the doctrine applicable.

Should it be argued that Appellant failed to exercise ordinary care to discover his danger, then the theory of assumption of risk would not apply, but would rather be properly charged as a defense of contributory negligence, and such defense was waived by the Appellee's own admission in the above cause (Tr. p. 316).

Certainly, when inexperienced travelers enter into agreements with skilled and professional carriers for hire in Glacier Park, Montana, to provide horseback trips to and from various places in the park, it cannot be held that such inexperienced persons assume the risk of everything that a horse may do. The general public has a right to be protected from and/or warned about propensities of horses, such as galloping, cantering or running. It is common knowledge among horsemen that inexperienced riders are for the most part unable to properly control and maintain themselves on a horse under such a gait.

A risk is not assumed where the conduct of the Defendant has left the Plaintiff no reasonable alternative. Evidence in this case indicates that the Appellee's guide caused Appellant's horse to gallop or run (Tr. pp. 200-201), and that the Appellant had no alternative but to attempt to remain in the saddle and stay mounted on the horse. He did not have an opportunity to dismount or avoid such active movement on the part of his mount. By placing the Appellant in such a situation or dilemma, the Appellee has deprived the Appellant of his freedom of choice and so can not be heard to assert that the Appellant has assumed the risk of such peril.

Certainly, in the case now before this Court, it was improper for the Trial Judge to allow Appellee, who caused the unusual situation or peril, through the galloping of its horse, to aver that the Appellant assumed the risk of such a perilous position created solely by the Appellee's negligence.

**STATEMENT AND ARGUMENT
REGARDING POINT TWO.**

This case involves renting a horse for use in transport. It is fundamental that a hiring of animals is a bailment.

A bailor of a horse is liable for injuries resulting therefrom if he should have known of its unsuitability for the purpose for which it is hired. *Dam v. Lake Aliso Riding School* (Calif. 1935), 48 P.2d 98, Aff'd 57 P.2d 1315; *Palmquist v. Mercer*, 272 P.2d 26; *Kersten v. Young*, 125 P.2d 501 (Calif. 1942); *Evans v. Upmier*, 16 N.W.2d 6 (Iowa 1944); *Conn v. Hunsberger*, 73 A. 324 (Penn. 1909), 25 L.R.A. (N.S.) 372; *Mateas v. Fred Harvey*, 9th CCA, 146 F.2d 989 (Ariz. 1945); and *Herbert v. Ziegler*, 139 A.2d 699 (Mo. 1958).

In the case of *Mateas v. Fred Harvey*, in an opinion by Judge Stephens of this Honorable Court, the rule was restated in a portion of the opinion, which is set out as follows:

“The rule is, as there announced, that:

“ ‘Livery-stable keepers who let animals for hire are bound only to exercise ordinary care and diligence in providing an animal suitable for the purpose for which it is hired.’ ”

“Hahn v. Rockingham Riding Stables, 126 N.J.L. 324, 19 A.2d 191, 192: ‘* * * From this (a corporation in business of hiring riding horses) it followed that the relationship of bailor and bailee, on this contract of hire, came into being between the parties and that the bailor impliedly warranted the horse as being fit for the purposes for which it was hired. * * *’

“*Kersten v. Young*, 1942, 52 Cal.App.2d 1, 125 Pac.2d 501, at page 503: ‘At the outset it should be noted that in a contract of hiring with one who rents horses for riding purposes, in the absence of any notice to the contrary there is contained an implied warranty to the rider that the renter of the animal knew or had exercised reasonable care to ascertain the habits of the horse and that the animal was safe and suitable for the purpose for which the keeper hired the horse to the renter thereof. To inform himself of the habits and disposition of horses which he keeps at his stable for hire is the duty of a stable-keeper, and if he knows or in the exercise of reasonable care should ascertain the fact that his animals are dangerous or unsuitable, he is liable for injuries to his customers resulting from the vicious propensities of animals so hired to his customer. *Dam v. Lake Aliso Riding School*, 6 Cal. 2d 395, 399, 57 P.2d 1315.’

“*Conn. v. Hunsberger*, 1909, 224 Pa. 154, 73 A. 324, at page 325, 25 L.R.A. N.S., 372, 132 Am.St. Rep. 770, 16 Ann. Cas. 504: ‘* * * It is the duty of a livery stable keeper to inform himself of the habits and disposition of the horses which he keeps in his stable for hire, and if he knows that they are dangerous and unsuitable, or by the exercise of reasonable care could ascertain the fact, he is liable for any injuries to his customers resulting from their vicious propensities. The law will not permit him to close his eyes and his ears, thereby remaining ignorant of the vicious habits of his horses, and relieve him from liability for injuries to a customer resulting from such habits. In his contract of hiring he impliedly engages that he knows, or has exercised reasonable care

to ascertain, the habits of his horses, and says to his customer that the horse which he lets is safe and suitable for the purpose for which he has hired it. His warranty is against defects or vicious habits, which he knows, or by the exercise of proper care could know; and, if he fails to exercise such care, and it occasions injury to his customer, he will not be relieved of liability, though he did not actually know the horse was unsuitable for the service. It is true a liveryman is not an insurer of the suitability of a horse or carriage let to a customer, but he is bound to exercise the care of a reasonably prudent man to furnish a horse or carriage that is fit and suitable for the purpose contemplated in the hiring. * * *

“The California Supreme Court adopted the language quoted from *Conn v. Hunsberger*, supra, in the case of *Dam v. Lake Aliso Riding School*, 1936, 6 Cal. 2d 395, 57 P.2d 1315, 1318, and explained: ‘* * * Under this rule the so-called implied warranty is not a warranty in that sense which insures the suitability of the horse, but is only a contractual obligation assumed against reckless or heedless hiring out of a horse without reasonable care to ascertain the habits of the animal with respect to its safety and suitability for the purpose for which it is hired.’”

The Appellant offered at the time of submission of instructions in the above entitled cause an instruction which would have informed the jury that a bailor of animals has a duty to inform the bailee or rider of the habits, traits, or propensities of the animals if the rider or bailee might be injured unless such warning is given to him. The bailor or owner of the animal,

or his agent, servant and/or employee, has a duty to warn the rider or bailee before the commencement of a sudden gallop of the animals, if the owner or his agent, servant and/or employee were riding in company with the rider and bailee as a guide or one in charge of a riding trip.

The Honorable Court failed to give this requested instruction and the jury was thus uninformed as to the legal relationship existing between one who rents animals for hire and that of the person hiring the animals. The jury, not having proper instruction as to the law pertaining to the relationship proven to exist in this case, was prevented from considering the duty of a bailor to his bailee, thus depriving Appellant of a fair trial upon the issues involved.

**STATEMENT AND ARGUMENT
REGARDING POINT THREE.**

The District Judge failed to submit written instructions relative to the law pertaining to common carriers. The undisputed evidence of the case raised the need for such instruction.

A carrier, according to the legal usage of the term, is one who, for hire, undertakes to transport persons or property from place to place. 9 *Am. Jur.* p. 429.

A contract for the carriage of property is a form or species of bailment, and the law of carriers, insofar as the transportation of property is concerned, is a development and extension of this phase of the law

of bailments. Insofar as it concerns the transportation of passengers, the common law of carriers is derived from the general principles of contracts, negligence, and torts. 9 *Am. Jur.* Section 1, p. 429. A common carrier may be defined, very generally, as one who holds himself out to the public as engaged in the business of transporting persons or property from place to place, for compensation, offering his services to the public generally. 9 *Am. Jur.* Sec. 4, p. 430. Everyone who offers to the public to carry persons, * * * is a common carrier of whatever he thus offers to carry. Sec. 8-701 *RCM* (1947).

Decisions of the State of Montana require that a carrier of persons for reward must use the utmost care and diligence for their safe carriage, must provide everything necessary for that purpose, and must exercise to that end a reasonable degree of skill. Sec. 8-405 *RCM* (1947), *Phillips v. Butte Jockey Club*, 46 M. 338, 127 P. 1011; *Brown v. Columbia Amusement*, 91 M. 174, 6 P.2d 874.

In the case now before the Court, under this law the jury should have been instructed as to the degree of care owed riders of rented horses by Appellee. Without this instruction, the jury was not advised that the utmost care and diligence should have been exercised by Appellee's guide in the control of both his horse and the horse of Appellant. There was required an instruction regarding the duty owed by a common carrier, since Appellee was, from the evidence, a common carrier within the meaning of the Montana law (Tr. pp. 26-27). The jury, not having any instruction as

to the duty of the common carrier, had no occasion to judge the Appellee's guide's duty of using utmost care and diligence for and on behalf of persons being carried by his rented horses. This deprived the Appellant of a full trial on his issues and theories of recovery.

**STATEMENT AND ARGUMENT
REGARDING POINT FOUR.**

Appellant maintains that the Honorable District Court erred in failing to instruct the jury relative to the law pertaining to invitees, in that the undisputed evidence raised such instructions and issues.

The owner who directly or impliedly invites others to enter his premises for some purpose of interest or advantage to him, owes to such persons a duty to use ordinary care in maintaining his property in a reasonably safe condition for use in a manner consistent with the purpose of the invitation and to not expose them to an unreasonable risk but to give them adequate and timely notice and warning. The liability of owners to an invitee for negligence in failing to render the property or chattel reasonably safe for the invitee or in failing to warn him of danger thereon, is predicated upon a superior knowledge concerning the dangers of the property to persons using same. 38 *Amer. Jur.*, Sections 96-97, pp. 754 through 757. *Herbert v. Ziegler*, 39 Atl. 2d page 699. In the instant case, it is without controversy that the Appellee and its employees had superior knowledge of the horses and their propensities. Their failure to warn Appellant

of these propensities or protect him from harm breached their common law duty and was a proper basis for liability. Failure to so charge the jury was error.

**STATEMENT AND ARGUMENT
REGARDING POINT FIVE.**

The Court erred in failing to submit instructions relative to the law pertaining to implied warranties.

In the absence of any notice to the contrary, there is an implied warranty to the rider in contract for renting a horse for riding purposes that the renter knew or had exercised reasonable care to ascertain the habits of the horse and that the horse was safe and suitable for the purpose for which the renter rented the horse. *Palmquist v. Mercer*, 272 P.2d 26.

It would seem to be a fundamental law that in every case where a horse is rented to another for riding purposes for a consideration, that there is a warranty by implication that the horse is suitable for the purpose intended. This would seem to be the majority rule and one that is well established by Appellate Courts in the horse bailment cases that have been decided.

In the present case, Appellant rented a horse for the purpose of walking on a trail to a scenic lake located a mile from Many Glaciers Hotel in Glacier Park, Montana. The evidence would show that the Appellant made it clear to the Appellee's guide that he was not an experienced horseman and had not ridden horses for many years. At this point the Appellee

had a duty to warrant that the horse rented to the Appellant was of a type that would be suitable to carry an inexperienced rider, and that the horse would under no conditions enter into any unusual gait or attitude which would result in loss of balance, position, or control of the mount. Persons who rent horses in national parks have a right to rely on the fact that horses rented to them will walk in a slow and regular manner and that they will not enter into an attitude which will create any danger for an inexperienced rider. It cannot be maintained that a running or galloping or cantering horse is being controlled in such a manner as to provide a safe seat for the inexperienced rider renting him.

The Court, through its failure to instruct the jury on the implied warranties that exist in this case, failed to give the jury the law which would have allowed them to find that the Appellee, through its agent, had breached its implied warranties, and the Appellant was thusly prevented from receiving the full benefit of the applicable law pertinent to his case.

**STATEMENT AND ARGUMENT
REGARDING POINT SIX.**

The District Court erred in failing to submit written instructions and issues, which were timely submitted, relative to the application of the rule of contributory negligence, as defined and tendered by the Plaintiff. Of necessity, in every controversy involving negligence or the absence thereof, there are two parties: the defendant and the person injured, or his

representative. Since knowledge of the parties is the test of liability, the question of liability is sometimes resolved in a negligence action as one of comparative knowledge—the knowledge of the defendant as against the knowledge of the person injured. In more familiar form, the proposition is as follows: liability is established when it is shown that the peril, being of the defendant's creation, was known to the defendant but not to the person injured. * * *

Fault can be predicated upon a person's conduct only where such conduct was a violation of duty on his part to exercise due care. There is no contributory negligence without violation of some duty and there can be no contributory negligence when no duty is placed on plaintiff to exercise care. *Knight v. La-Grande*, 127 Oregon 76, 271 Pac. 641, 61 A.L.R. p. 256; 38 *Amer. Jur.* pp. 858, 859 and 862.

The Court's instruction to the jury in regard to the Appellant's contributory negligence was erroneous and prejudicial to his rights.

**STATEMENT AND ARGUMENT
REGARDING POINT SEVEN.**

The Court failed to allow the Appellant to amend his complaint as allowed under the authority of Rule 15(b), so as to add another count of negligence to Appellant's complaint, it being alleged as negligence the failure of Appellee's guide to instruct the Appellant in the propensities of his mount to follow and do everything that the lead mount would do.

Rule 15(b) of the Federal Procedure says as follows:

“When issues not raised by the pleadings are tried by express or implied consent of the parties, they shall be treated in all respects as if they had been raised in the pleadings. Such amendment of the pleadings as may be necessary to cause them to conform to the evidence and to raise these issues may be made upon motion of any party at any time, even after judgment; but failure to so amend does not affect the result of the trial of these issues. If evidence is objected to at the trial on the ground that it is not within the issues made by the pleadings, and the court may allow the pleadings to be amended AND SHALL DO SO FREELY when the presentation of the merits of the action will be subserved thereby and the objecting party fails to satisfy the court that the admission of such evidence would prejudice him in maintaining his action or defense upon the merits.”

The Court seriously limited the Appellant's right to present all aspects of Appellee's negligent conduct by its failure to allow the requested amendment at the conclusion of Appellee's case (Tr. p. 16).

Under Rule 15(b), an amendment shall be allowed to conform the pleadings with the actual issues and proof upon which the case was tried. In the case at bar, the record indicates that Appellee through its agent, wholly failed to instruct or advise Appellant, in any way, as to the propensities of his mount to suddenly break into a gallop or canter when and if the Appellee's lead horse should do so (Tr. p. 50).

This evidence was squarely presented to the jury, and the jury should have been allowed to consider this failure or omission on the part of the Appellee's guide, as a further count of negligence upon which to base the liability of the Appellee.

The test to be applied in all cases where an amendment is requested, is to consider whether or not Appellee would be prejudiced by such an amendment. In the case at bar it is obvious from the record that the Appellee could not have been prejudiced in any manner, as such proof was elicited from Appellee's own guide and agent. Appellee having examined the witness fully and met the issues squarely, cannot fairly state any argument that he would have been prejudiced by such an amendment.

Appellee did not object to nor cross-examine the guide Virgil Dillon as to such line of questioning pertaining to whether or not Appellant had riding experience, or was given instructions prior to mounting said horse (Tr. p. 50). It would seem that such failure of Appellee to object or cross-examine the witness would, by consent, create the right to amend the complaint at the conclusion of the evidence so as to allow a formal allegation of negligence based on such theory.

Rule 15(b) provides that issues tried by express or implied consent should be treated as if raised in the pleadings. The Court must make findings on such issues and failure to submit a case to the jury on a particular theory which is presented by the evidence may be grounds for a new trial, even though the evidence is not sufficient to support the verdict on the

theory on which the case went to the jury. *Levin v. Coe* (App. DC 1942), 132 F.2d 589, 6 FR Serv. 15b 1, Case 2; *Wall v. Brim* (CCA 5th, 1943), 138 F.2d 478, 7 FR Serv. 15b 1, Case 3; *Franklin v. Columbia Terminals Co.* (CCA 8th, 1945), 150 F.2d 667.

CONCLUSION.

The Honorable Trial Court erred in his interpretation of the doctrine of assumption of risk, as the record shows that this doctrine is or was inapplicable. The defense of assumption of risk is an affirmative defense and must be proven by the defense. Hence, the Appellee failed to discharge his burden of proof on this point, and such instruction by the Court deprived Appellant of a fair trial.

The Honorable Trial Court's refusal to submit to the jury instructions offered by Appellant that a hired animal is a bailment; his refusal to submit to the jury an instruction relative to the duty of a common carrier; his refusal to submit to the jury an instruction relative to the law of implied warranty and bailment contracts, so limited the jury's consideration of this cause of action as to amount to a directed verdict in behalf of the Appellee, and deprived Appellant of a fair consideration by the jury of his cause.

Appellant earnestly contends that the Court erred in failing to allow Appellant to amend his complaint under and by virtue of the authority of Federal Rule 15(b), thus depriving Appellant of the additional count of negligence that Appellee's guide failed to

instruct Appellant as to the traits of the mount in question, following and performing in the same manner and gait which the Appellee's mount would perform. Appellant's request to amend was timely requested and filed and the Court's failure to allow said amendment was the grossest of error.

Appellant earnestly submits that in view of the points relied upon, and the law discussed in the cases cited above, consistent with justice within our framework of law and statutes, that the same demands the reversal of this cause and the remanding of same for a new trial.

Respectfully submitted,

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By PHILIP S. KOURI,

One of Counsel.

No. 16,483

**United States
Court of Appeals
for the Ninth Circuit**

DR. ROBERT L. HARGRAVE,

Appellant,

vs.

E. G. WELLMAN, doing business as Wellman
Enterprises,

Appellee.

BRIEF OF APPELLEE

ART JARDINE,
JOHN D. STEPHENSON,
ALEX BLEWETT, JR.,
JOHN H. WEAVER, and
GEORGE N. McCABE

Filed, 1959

..... Clerk



FILED

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**United States
Court of Appeals
for the Ninth Circuit**

DR. ROBERT L. HARGRAVE,

Appellant,

vs.

E. G. WELLMAN, doing business as Wellman
Enterprises,

Appellee.

BRIEF OF APPELLEE

STATEMENT OF THE CASE

The factual situation in this case is rather simple, and generally appellant's statement is acceptable. Appellant controverts certain statements, which are as follows:

1. The sudden movement of the guide's horse caused appellant's horse to suddenly lunge forward and run;
2. There was sudden jolting or bolting by appellant's horse;
3. Appellant's horse had a propensity to bolt and that defendant's guide, Dillon, knew of such propensity;

4. Defendant's guide was under the duty to warn appellant that such horse would run;

for the reason that the evidence in this case is contra. The evidence negatives causal connection between the running of appellant's horse and the running, if any, on the part of the guide's horse. Likewise, there is no evidence that the appellant's horse jolted or bolted (Tr. p. 152); the horse didn't rear or shy (Tr. p. 156). There is no evidence that this horse had a propensity to do anything different from what any other normal horse would do.

STATEMENT OF THE PLEADINGS:

Unfortunately, the record before this Court is not as clear as it should be as to the pleadings under which Appellant claims to have proceeded in this case. As is stated in Appellant's Brief, there was a stipulation by and between counsel as to the theory on which plaintiff would proceed. Appellee's understanding of the stipulation was that plaintiff's case would proceed on the following theory:

1. Whether or not Dillon, defendant's guide, suddenly caused his horse to gallop;
2. If, in fact, Dillon did cause his mount to gallop, whether this caused Plaintiff's mount to bolt, gallop and run; and
3. Whether or not such action on the part of Dillon would be negligence.

While the above is set out in more detail than is the statement in the Appellant's brief, we think there is agreement on this point.

In designating the record, Appellant did not see fit to include therein the proposed amendment to the pleadings which has given rise to Appellant's specification of error designated as Point Seven. Why Appellant elected against incorporating in the record the language of the proposed amendment is something only within his own knowledge, but on this appeal, counsel for Appellee is not willing to agree that the proposed amendment in the words and language employed by Appellant in his brief is identical with the proposed amendment made in the lower court. Notwithstanding this, reference is made to a blanket objection offered by counsel for Appellee to evidence not in accord with the discussion and stipulation had prior to trial as to the theory on which appellant would proceed. (Tr. p. 30). It is the position of Appellee that any evidence that went in the case other than or different from evidence having to do with the stipulation hereinabove referred to went in over objection.

COURT'S JURISDICTION:

Appellee concedes the jurisdiction of the District Court on the grounds of diversity of citizenship and the amount in controversy exceeding the then statutory sum of \$3,000.00. Appellee concedes that the appeal was regularly taken except for the time in which Appellant's brief was filed but on this point Appellee desires to make no issue.

APPELLANT'S POINTS OF ERROR:

Number One — Assumption of Risk. Appellant argues that the lower court should not have given the following instruction on assumption of risk: (Tr. 320)

“The defendant was not an insurer of the safety of the plaintiff. A person who rides a horse hired for that purpose assumes or takes upon himself the ordinary risks incident to such riding. The plaintiff assumed all risks which he knew or, in the exercise of ordinary care, should have known, were inherent in the trip. But the plaintiff did not assume any additional risks which were proximately caused by the failure of the defendant, if any, either before or at the time of the accident, to exercise ordinary care under the circumstances.

In other words, if the plaintiff's horse suddenly started running, as alleged, it is then a question of whether that running was one of the ordinary risks incident to horseback riding under the circumstances of this case. If you find from the evidence that the running of plaintiff's horse was caused by negligence of Virgil Dillon, as defined elsewhere in these instructions, then that was not a risk assumed by the plaintiff. If you find from the evidence that plaintiff knew, or, in the exercise of ordinary care, should have known that a suitable saddle horse might start running in that manner, then that was a risk which was assumed by the plaintiff.”

The only objection urged by Appellant in the lower court was on the ground that the instruction failed to include a statement that the doctrine of assumed risk is not applicable “if the Plaintiff was not in any way at fault” (Tr. 326-327). On this appeal argument

is now made that there was error in the instruction for the reason that there is no evidence showing that the Plaintiff knew the horse might suddenly run. In the eyes of the Appellee the ground as now asserted is different from that asserted in the lower court, so that Appellant is squarely within the rule that a party may not for the first time on appeal raise an objection different from the objection in the trial court. See Rule 51, Rules of Civil Procedure, as follows:

“Rule 51. Instruction to Jury: Objection.

At the close of the evidence or at such earlier time during the trial as the court reasonably directs, any party may file written requests that the court instruct the jury on the law as set forth in the requests. The court shall inform counsel of its proposed action upon the requests prior to their arguments to the jury, but the court shall instruct the jury after the arguments are completed. No party may assign as error the giving or the failure to give an instruction unless he objects thereto before the jury retires to consider its verdict, stating distinctly the matter to which he objects and the grounds of his objection. Opportunity shall be given to make the objection out of the hearing of the jury.”

A ground of objection to an instruction given the jury first presented on appeal is not timely made and cannot, therefore, be considered. **Christensen v. Trotter, et al.** (Ariz.) CCA 9th, 171 F 2d 66; **Lang v. Rogney**, (Minn.) CCA 8th, 201 F 2d 88; **Nesbit v. Everette**, (Fla.) CCA 5th, 243 F 2d 59.

If for the sake of argument it can be said that

Appellant's present objection is substantially the same as the objection urged in the lower court, he still gains no relief for the Appellant's own testimony shows that during his youth his father had horses (Tr. 80); that he had ridden horses a few times (Tr. 81); that he rode before he went to the University, and once or twice after starting medical school; that he rode in 1948 or 1949 in the State of Washington (Tr. 81). Appellant could not remember if he had ridden since that time (Tr. 81). Appellant testified that on the trip involved here and prior to the accident, his horse was in the rear (Tr. 88) and that his horse would get behind and then jog to catch up (Tr. 90), and he would just let the horse jog (Tr. 90). Thus the Appellant knew that his horse would follow the other horses and would attempt to keep up with them. While Appellant argues that the record shows he was not an experienced rider, that statement of Appellant applies to the period of his life prior to his reaching his eighth birthday. (Tr. 80) Actually the record before this Court shows that the Appellant, while perhaps not an experienced rider, was acquainted with and had had experience with horses. This experience, together with the knowledge acquired by the Appellant from his riding the horse involved to the lake, without question allows for the application of the doctrine of assumed risk as laid down by the lower court in its instruction to the jury. There is no question but what the doctrine of assumption of risk applies to livery stable

cases and that the instruction given by the Court (Tr. 320) is proper.

In **Fred Harvey Corporation v. Mateas**, (Cal.) CCA 9th (1948) 170 F 2nd 612, the court said, at page 615:

“ . . . The plaintiff assumed all risks which he knew, or in the exercise of ordinary care should have known, were inherent in the trip; but the plaintiff did not assume any risk which was proximately caused by the failure of the defendant, either before or at the time of the accident, to exercise ordinary care under the circumstances.”

And in **Reynolds v. Kenwood Riding Club** (Ohio) 18 NE 2d, 612, the Court said at page 614:

“One who rides a horse, which he has hired for that purpose, takes the ordinary risks incident to such pursuit . . .”

“When there is no evidence of any known trait, condition or propensity of the horse, which would subject the rider to greater risks than ordinarily attach to horseback riding, it is error for the trial judge to submit such case to the jury . . .”

See, also, **Clifton v. Holliday** (Ohio) 88 NE 2d 304; 15 ALR 2d, § 10, p. 1323;

Vanigan v. Mueller (Wis.) 1932, 243 NW 419;

Smith v. Pabst (Wis.) 1939, 288 NW 780.

Without the aid or support of any authority whatsoever, Appellant urges that the instruction on assumption of risk was erroneous in that it states that Appellant assumes any risk of which he should have known in the exercise of ordinary care. In this respect, Appellant is arguing directly contrary to the Instruction No. 5 which he proposed. (Tr. 13)

Lastly, Appellant contends that there could be no assumption of risk brought about by Dillon's causing his horse to gallop, but this argument is clearly and fully covered in the Court's instruction which advised the jury that the Appellant did not assume any additional risk caused by the negligence of the Appellee (Tr. 320). Specifically, the Court instructed the jury that if Appellee's agent, without warning, suddenly and negligently caused Appellant's horse to run, then Appellant did not assume such risk. Indeed it is difficult to see how the lower court could have better presented this matter to the jury.

POINT TWO—BAILMENT

POINT FIVE—IMPLIED WARRANTY

These two points, while argued separately in Appellant's brief, are so closely related that they will in this brief be treated together. A further reason for their being treated together in the Appellee's brief lies in the court's instruction to the effect that counsel for Appellant withdrew from consideration of the jury any theory of negligence in furnishing an unsuitable horse (Tr. p. 316). Also, as is conceded by Appellant in his brief under caption STATEMENT OF THE PLEADINGS, the theory of unsuitability or warranty was abandoned and withdrawn. The Appellant is now squarely faced with the general rule of law applicable as follows:

“Ordinarily, where an issue is abandoned or expressly withdrawn by the parties, the court should not submit it to the jury, and no instruction should

be given on such issue.” (See 88 C.S.J.—Trial—Section 275, page 737.)

Thus the record itself disposes of these two points; consequently, it isn't clear to the Appellee why argument is devoted thereto in the Appellant's brief. Because of such argument, however, Appellee does feel that response should be made.

Appellant urges error on the part of the lower court in failing to give plaintiff's proposed instruction No. 2 (Tr. pp. 11 and 12) on the duty of a bailor of animals to warn the bailee of the habits, traits or propensities of the animal.

Under plaintiff's proposed instruction, it could be argued that recovery could be had for any habit which a horse possessed, whether the habit was vicious or not. Actually, it is only for dangerous or vicious habits or traits which the livery stable keeper knew or in the exercise of reasonable care should have known that he can be held liable in the event of injury to a rider. See *O'Brien v. Gateway Stables* (Cal.) 231 Pac. 2d. 524, and *Palmquist v. Mercer* (Cal.) 272 Pac. 2d. 26. To the same effect are the cases cited by Appellant, namely: *Mateas v. Fred Harvey*, (Cal.) C.C.A. 9th, 146 Fed. (2) 989—bucking; *Hahn v. Rockingham Riding Stables, et al* (N.J.) 19 A 2d, 191—tired horse collapsed; and *Kersten v. Young* (Cal.) 125 Pac. 2d. 501—rearing and falling; *Dam v. Lake Aliso Riding School* (Cal.) 1935, 48 Pac. 2d. 98—jumping; *Conn v. Hunsberger* (Pa.) 1909, 73 A 324—runaway).

In a situation such as here presented, there is no

practical difference in the application of the law of negligence and the law of implied warranty so far as duty imposed upon the defendant is concerned. See **Koser v. Hornback (Idaho) 265 Pac. 2d. 988**, where the court says at page 991:

“... one who lets a horse for hire, although not an insurer of the horse's fitness, is under an obligation, sometimes spoken of as an implied warranty, to furnish an animal which is reasonably safe for the purpose known to be intended, and for a failure to use due care to discover dangerous propensities in such animals, or to disclose them to the hirer, he may be held liable for personal injuries or death resulting from such neglect.”

Going on, the court says that the form of action was of no consequence and at page 991 uses the following language:

“... because the courts all agree that the bailor is not an insurer, and that a mere breach of the implied warranty is not alone sufficient ground for recovery. In addition thereto the plaintiff must prove that the keeper had some knowledge, or the facts are such as to charge him with knowledge of the unsuitability of the animal; or negligence in failing to take reasonable precaution to determine its suitability; or in failing to warn the prospective rider of the facts. So whether the action be ex contractu or ex delicto, the required proof is the same. . . .”

Such also is the holding in **Mateas v. Fred Harvey, (Cal) CCA 9th, 146 Fed. 2d. 989**.

The record in this case is void of any evidence of dangerous or vicious propensities of the horse involved. The horse did not shy, jump or veer (Tr. pp. 152 and 156); all it did was run. Certainly the fact

that a horse will run when other horses run does not in itself indicate a dangerous or vicious trait or habit.

See **Troop A Riding Academy v. Miller (Ohio)** 189 N.E. 647, where the court at page 649 says:

“A horse of ordinary spirit that will not run away under any circumstances would be a rare animal, and to hold that, simply because one did run off on one occasion, a jury would be justified in finding that he was vicious, wild, or prone to run, would enable jurors to find verdict on mere speculation and guesses, instead of evidence.”

Another case also disposing of Appellant’s argument in this respect is **Clifton v. Holliday (Ohio)** 88 N.E. 2d. 304, where on pages 306 and 307 the court said:

“Wherever horses are used for riding, there is present a contest of wills, the inclination of the horse and the purpose of the rider. If the latter does not know how to control the normal horse, obviously the horse will have its way. Again, there is no evidence that this particular horse had any characteristic not possessed by riding horses in general, which would prevent normal control of its actions.”

POINT THREE—COMMON CARRIER

Appellant alleges error in the failure of the Court to give plaintiff’s proposed instruction No. 8 (Tr. p. 15) to the effect that defendant was a common carrier. Without exception, the cases hold that a livery stable keeper is not a common carrier and that he owes only the duty of ordinary care toward his customers.

See 54 CJS, Livery Stable Keepers, Section 16, p. 645:

“A livery stable keeper is **not a common carrier**, as discussed in Carriers § 534, and is not bound to let his horses to every one who seeks to hire them; nor is he bound to use the utmost care and skill in furnishing a horse, vehicle, harness, and driver to a customer, but his duty in the premises is to use ordinary care and skill . . .” (Emphasis ours)

and

15 ALR 2d. § 2, pp. 1314 and 1315 where it is said:

“He owes a duty to furnish a horse which is reasonably fit and suitable for the purpose for which it is let . . .

An owner is not an insurer of the suitability of the horse he lets, but he must exercise the care of a reasonably prudent man to provide a horse suitable for the purposes contemplated in the hiring . . .

The duty required is that of ordinary care and diligence.”

In **Dam v. Lake Aliso Riding School (Cal.) 1936, 48 p. 2d, 98**, affirmed in **57 p. 2d, 1315**, where plaintiff was thrown by defendant's saddle horse, the Court said at page 100:

“ . . . The respondent was not a common carrier . . . Ordinary care is the test to be used. Due regard should be given to the selection of the horse, the purpose of its use, and the ability of the bailee to control horses generally if this fact is ascertainable . . . Once a horse passes from the bailor to the bailee, then the bailee controls its movements.”

To the same effect: **Fred Harvey Corporation v. Mateas, (Cal.) CCA 9th, 1948, 170 F. 2d, 612; Cooper**

v. Layson Bros. (Ga.) 80 SE 666; Conn v. Hunsberger (Pa.) 73 A. 324; Willis v. Schuster (La.) 28 So. 2d, 518.

The statute, R.C.M. 1947, 8-405, relied upon by the Appellant is merely declaratory of the common law, (Taillon v. Mears, 29 Mont. 161, 74 p. 421), which common law theory has been rejected by all the courts in livery stable cases, supra, because of the lack of control over the horse by the livery stable keeper.

Appellant relies upon the Montana case of **Phillips v. Butte Jockey Club**, 46 Mont. 338, 127 P. 1011, wherein the court rejected the theory of carrier for hire for injuries sustained by an invitee in the grandstand at defendant's racetrack. Also appellant cites **Brown v. Columbia Amusement Co.**, 91 Mont., 174, 6 P. 2d, 874, wherein the court held that a merry-go-round operator owed the duty of ordinary care toward minor children invited to ride the machine, rejecting plaintiff's contention, on appeal, that the defendant was a carrier of passengers for hire.

It is clear, the court committed no error on this point.

Point Four—Invitee Relationship. Error is asserted in the Court's failure to give Appellant's proposed instruction No. 9 (Tr. pp. 15 and 16) relating to the duty owed an invitee.

Appellant cites no cases which would support application of the rule where the injury occurred at a place outside and beyond the owner's possession or control. On the basis of research conducted by Ap-

pellee, it is clear that the doctrine is limited to those cases wherein the injury is sustained by reason of defective premises under the control of the party charged. Appellant's citation of authority, 38 Am. Jur.—Negligence § 96, p. 754, sustains this view. There it is said:

“ . . . The rule is that an **owner or occupant of lands or buildings**, who directly or impliedly invites others to enter for some purpose of interest or advantage to him, owes to such persons a duty to use ordinary care to have his **premises** in a reasonably safe condition . . . ” (Emphasis ours)

In 38 Am. Jur.—Negligence § 94, p. 753, it is said:

“A person who makes use of a dangerous **place** for his own purposes may be held liable to respond in damages for an injury which results therefrom notwithstanding he cannot control the substance or thing which makes the place dangerous. However, the liability of an **owner or occupant of real estate** in reference to injuries caused by a dangerous or defective condition of the premises depends in general upon his having control of the property. In fact, such liability depends upon control, rather than ownership, of the premises . . . ” (Emphasis ours)

The case of **Herbert v. Ziegler** (Md.) 139 A. 2d, 699, sheds no light upon the case at bar for there it clearly appears that the injury occurred on premises under the control and possession of the defendant and was caused by defendant's dog frightening the plaintiff's horse.

In all the Montana cases, the doctrine of invitee has been applied only in those cases when the injury occurred on premises owned or occupied by the de-

fendant. See **Ahlquist vs. Mulvaney Realty Co.** 116 Mont. 6, 152 Pac. 2d 137; **McCulloch v. Horton** 102 Mont. 135, 56 Pac. 2d 1344; **Chichas v. Foley Brothers Grocery Co. et al**, 73 Mont. 575, 236 Pac. 361. Our research has failed to reveal any case which would extend the doctrine as urged on behalf of Appellant in this case, that is, to make the rule applicable for use of a hired chattel for injury happening away from or off the premises, so to speak. Supporting the Appellee's position that the doctrine is not so extended is the case of **Johnston v. De La Guerra Properties**, (Cal.) 170 Pac. 2d 5, where the Court says on Page 9:

“ . . . A tenant ordinarily is not liable for injuries to his invitees occurring outside the leased premises on common passageways over which he has no control. . . . ”

The same rule is applied in **Paine v. Hampton Beach Improvement Co.** (N.H.) 100 At. 2d 906; **Stoddard et al v. Roberts Public Markets**, (Cal.) 80 Pac. 2d 519; **Williams v. Wolf** (Pa.) 84 Atl. 2d 215.

While it may be argued that the four cases above cited are not precisely in point with the question here involved, nonetheless the burden here rests upon the appellant and in this he has failed. As stated above, there is a total lack of authority for this position and it must be disregarded.

POINT FIVE—IMPLIED WARRANTY

(See Argument on Pages ~~9-12~~)

8-11

POINT SIX—CONTRIBUTORY NEGLIGENCE

Again it is not clear to counsel for Appellee why time and space in argument is devoted to the question of contributory negligence. As the record shows (Tr. p. 316), the issue of contributory negligence was withdrawn from consideration by the jury. This being so, there would be no reason for the court to give plaintiff's proposed instruction No. 4 (Tr. pp. 12 and 13). In fact, the court refused to give an instruction on contributory negligence and Appellant in the lower court made no objection to the court's failure to so instruct. Therefore, Appellant is precluded under Rule 51 of the Federal Rules of Civil Procedure from now asserting this as error. Further argument on this point is deemed unnecessary.

POINT SEVEN—AMENDMENT OF PLEADINGS

As stated by Appellee under caption STATEMENT OF THE PLEADINGS, the court does not have before it the language of the proposed amendment which now gives rise to Appellant's complaint of error. In spite of this, Appellant would seek to have this court set aside the lower court's ruling. This cannot be done in the face of the general rule that all possible presumptions are indulged to sustain the action of the trial court. See **T.V.T. Corporation, et al v. Basiliko, et al.**, (D.C.) 257 F. 2d. 185, at page 187, where the court says:

The difficulty with appellants' position here is that they have not given this court an adequate record

for considering their claims. To quote the Seventh Circuit:

‘All possible presumptions are indulged to sustain the action of the trial court. It is therefore, elementary that an appellant seeking reversal of an order entered by the trial court must furnish to the appellate court a sufficient record to positively show the alleged error.’ In *re* Chapman Coal Co., 1952, 196 F. 2d. 779, at page 785.

On this appeal, appellants have given us as a record only the pleadings in the instant case, the motions for summary judgment, the judgments entered, and the notice of appeal. Under the circumstances, this is plainly insufficient.”

See, also *Whiteley v. Foremost Dairies, Inc.* (Ark.) CCA-8, 254 F 2d. 36; *Haug v. Grimm* (N.D.) CCA-8, 251 F 2d 523; *The Elgin Corporation v. The Atlas Building Products Company* (N.M.) CCA-10, 251 F. 2d. 7; *Complete Auto Transit, Inc. v. Floyd*, (Ga.) CCA-5, 249 F 2d. 396.

Related to the same question and in support of Appellee’s position are the following Ninth Circuit cases:

State Farm Mutual Auto Insurance Co. v. Porter, (Cal.) 186 F. 2d. 834; and *Pellegrino v. Nesbit*, (Cal.) et al. 203 F. 2d. 463.

Should the court conclude that from the Appellant’s brief it can consider the point now urged appellant’s argument nonetheless lacks merit and legal support. From the testimony of the Appellant alone, it is clear that there is no causal connection between the alleged negligent act or omission and the alleged injury.

To summarize, Appellant conclusively established:

1. The horse did not rear or shy (Tr. p. 156);

2. The horse just started to run (Tr. p. 156);
3. Plaintiff remained on the horse, in the saddle with hands on reins and feet in stirrups at all times (Tr. pgs. 154-155);
4. Appellant knew the horse's tendency to close the gap so to speak; (Tr. p. 90);
5. Plaintiff stopped or slowed his horse to take pictures (Tr. pgs. 144-145).

To quote **Reino v. Montana Mineral Land Development Co.**, 38 Mont. 291, 99 Pac. 853, at page 854: (Pac. Reporter).

“ ‘Negligence is the cause of the accident, in a legal sense, only when it is of such a character as that men of ordinary prudence, judgment, and experience ought reasonably in the light of the attending circumstances to have foreseen that it was likely to produce such an accident.’

In 1 Thompson's Commentaries on the Law of Negligence, it is said: ‘As will more fully appear in the next title, the law does not impute negligence to an injury that could not have been foreseen or reasonably anticipated, as the probable result of a given act or omission. * * *’ Section 28. ‘It follows that the negligence of a person cannot be the proximate cause of a harm to another following it, unless, under all the attending circumstances, ordinary prudence would have admonished the person sought to be charged with the negligence that his act or omission would probably result in injury to some one. The general test as to whether negligence is the proximate cause of an accident is therefore said to be whether it is such that a person of ordinary intelligence should have foreseen that an accident was liable to be produced thereby.’ Section 50.”

Under the circumstances as related by the appellant in his own testimony, it cannot be said that the injury, if any, sustained by the appellant was proximately caused by the alleged failure on the part of Dillon to warn plaintiff as to the tendency of plaintiff's mount to follow. Nor can it be said that the situation would have been different if, in fact, a warning was or could have been given,

Generally on the application of Rule 15 (b) of the Federal Rules of Civil Procedure with reference to amendment of pleadings to conform to evidence see: **Macris v. Sociedad Maritima San Nicolas**, (N.Y.) CCA 2d 245 F. 2d, 708, wherein amendment was denied where the evidence adduced at trial showed no breach of duty by the defendant or causal connection between the acts of defendant and plaintiff's injury. Also see **Chesapeake & Ohio Railway Company v. Newman** (Ohio) CCA 6th, 243 F. 2d, 804, where permission to amend an answer to conform to proof of a new defense was denied, in which case the court on pages 812 and 813 said:

“ . . . It is clear that the case was tried without pleading or evidence in support of the proposed new issue. Rule 15, 28 U.S.C.A. Federal Rules of Civil procedure is not applicable under the facts of this case . . . ”


“Rule 15(b) of the Federal Rules of Civil Procedure under which appellant sought to amend his answer, clearly is applicable only when as stated, in the rule, the amendment is to ‘conform to the evidence.’ It is also stated in the rule that the issue or issues sought to be included in the amendment

must have been 'tried by express or implied consent of the parties.' In the instant case the court did not find sufficient evidence which required an amendment so that the pleadings would conform to the evidence . . . The trial court is vested with sound discretion in granting or refusing leave to amend, and under the circumstances in the instant case, we find no abuse of that discretion. *Carrol v. Funk*, 9 Cir. 222 F. 2d, 508 . . ."

In view of the standing objection made by counsel for appellant, It cannot be said in the instant case that the new issue now asserted by appellant was tried with the express or implied consent of the parties. (Tr. p. 30).

It is respectfully submitted that the appeal be dismissed, and that the judgment of the lower court be affirmed.

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No. 16485

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

JOHN ALEXANDER RYAN,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLEE'S BRIEF.

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JOHN ALEXANDER RYAN,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLEE'S BRIEF.

Statement of Jurisdiction.

An Information in twenty-one counts was filed against appellant on October 3, 1958 and amended during trial. Appellant pleaded not guilty to the Information on November 10, 1958. A jury trial of the Information commenced on January 12, 1959, which was concluded on January 26, 1959 by a verdict of guilty on Counts 2, 3, 4, 7, 8 and 18. These counts were the only ones submitted to the jury, the others being dismissed prior to submission of the case to the jury.

On January 30, 1959 judgment was entered, the appellant being sentenced on each of the aforesaid counts to be committed to the custody of the Attorney General for a period of one year, to run concurrently. Appellant also was fined \$1,000 upon Count 2, \$4,000 upon Count 3 and \$2,000 upon each of Counts 4, 7 and 8, or a total

fine of \$11,000. A timely notice of appeal was filed on February 2, 1959, and appellant is at liberty on bail pending disposition of the appeal.

The District Court had jurisdiction under the provisions of 18 U. S. C., Sections 202 and 3231. This Court has jurisdiction under the provisions of 28 U. S. C., Section 1291.

Statute Involved.

Construction and interpretation of 18 U. S. C. Section 220 is one of the issues in the appeal. Section 220 reads as follows:

“Whoever, being an officer, director, employee, agent, or attorney of any bank, the deposits of which are insured by the Federal Deposit Insurance Corporation, of a Federal intermediate credit bank, or of a National Agricultural Credit Corporation, except as provided by law, stipulates for or receives or consents or agrees to receive any fee, commission, gift, or thing of value, from any person, firm, or corporation, for procuring or endeavoring to procure for such person, firm, or corporation, or for any other person, firm, or corporation, from any such bank or corporation, any loan or extension or renewal of loan or substitution of security, or the purchase or discount or acceptance of any paper, note, draft, check, or bill of exchange by any such bank or corporation, shall be fined not more than \$5,000 or imprisoned not more than one year or both.”

The sole points on appeal are the appropriateness of two instructions to the jury and not the sufficiency of the evidence. Nevertheless, appellee will set forth a brief résumé of the facts below because an understanding of

the case may be helpful to the Court and because some nineteen pages of appellant's Brief concerned a statement or analysis of the evidence. In its summary, appellee will take the construction of the evidence most favorable to it, together with all available inferences, not only out of a natural disposition to do so, but because such is the rule of law.

Summary of Evidence.

I. Counts, Four, Seven and Eight.

These counts pertain to three payments of \$1500 each by Jack Ewins, as represented by three checks, Exhibits 38, 39 and 40 for loans to the Cahuenga Development Corporation.

Ewins testified that he came to appellant for a loan, but that Ryan insisted first upon a payment of \$6500, complaining that Ewins had not paid him with respect to a previous loan for Arlington Building Corporation [R. T. 100].* According to Ewins, Ryan defined the issue rather bluntly:

“[I]f I didn't want to work with him, . . . I needn't come to see him for a loan.” [R. T. 100].

Because of Ewins' need for the loan and Ryan's position as a “kingpin,” Ewins promised to pay \$4500, which Ryan graciously conceded could be paid in three installments out of the Loan proceeds [R. T. 116]. Three checks for \$1500 each, Exhibits 38, 39 and 40, payable to C. M. Owens, thus were made out by Lucretia Ewins and mailed to appellant's residence [R. T. 110-111, 154, 157].

Catherine M. Owen, a resident of Arcata, California, and longtime friend of appellant [R. T. 426], received

*“R. T.” will refer to the Reporter's Transcript of Proceedings.

Exhibit 38 accompanied by a desk pad memorandum of appellant [Ex. 67-A], which stated:

“Dear Caty, First Installment \$1500. Two more to follow. JAR” [R. T. 436, 819].

A letter from appellant's wife [Ex. 68-B] transmitted the second \$1500 check [Ex. 39; R. T. 440-441]. The third check [Ex. 40] was endorsed by Mrs. Owen on December 27, 1954, and was given by her to the Valley National Bank as a portion of the payment for a cashier's check which, together with other checks, was given to appellant at that time and place [R. T. 446-447, 780].

II. Counts Two and Three.

These counts involve, respectively, payment of \$700 and \$3725 to appellant for loans made to the Arlington Builders Corporation.

On numerous occasions, appellant stated to shareholders of the Corporation that he was very influential in getting loans through the bank, he was entitled to extra compensation as a result, and if Arlington would continue to take care of him on payments, he would continue to render valuable services to the Corporation [R. T. 239, 257, 121, 124]. Finally appellant Ryan became more specific, telling Julius White, secretary of the Corporation, that he required money for having put their loan through [R. T. 242-244]. He told Wendell P. Harding, that a “finder's fee” could be paid him; when Harding made it clear that no cash payments would be made, Ryan said he would supply the name of a party to whom a check could be made payable [R. T. 275]. Ryan then instructed White that the payee of the check should be “TruBilt Homes,” to note on the check that it was for “finder's fee on real estate” and to mail it to C. M. Owen in

Arcata, California [R. T. 244-247]. Pursuant to this arrangement, Mrs. Owen received Exhibit 44, a \$3725 check drawn by Arlington Builders. The proceeds of this check, along with the \$4500 Ewins paid for Ryan's benefit, were returned to Ryan on December 27, 1954 at the Valley National Bank in the form of a cashier's check and other checks, which were deposited to an account for appellant's children at the Pasadena Savings & Loan Association [R. T. 797-798].

On another occasion, Ryan stated that he needed money from Arlington Builders because he was taking a trip to Hawaii [R. T. 249-250]. This hint resulted in a \$700 payment by shareholders of Arlington one evening at Ryan's home [R. T. 252, 273, 292], which is the basis of Count Two.

III. Count Eighteen.

This count involves the payment of \$1687 to appellant by the Triangle Development Corporation for a loan obtained through Ryan from the Bank of America.

Two or three months after the Corporation had obtained the loan, appellant proceeded to the office of Ray Connors, a one-third shareholder of the Corporation, in order to discuss Ryan's compensation for having made the loan [R. T. 174]. Connors mentioned the reluctance of his partner Dohn to enter into a transaction so odious, but Ryan won his point by telling Connors that Dohn

“should be made aware of the importance or contribution he [Ryan] could make in this regard.” [R. T. 176].

The arrangement was put upon a “business-like” basis of one-half of one percent of the face value of the loan, which arrangement was “acceptable” to appellant [R. T. 176].

Appellant instructed Connors to use the name of Ray E. Viers as the payee upon Ryan's compensation check [R. T. 179]. As a result, Exhibit 41, a check for \$1687, was drawn to Viers' favor [R. T. 178-179] which was then cashed by Viers who gave the proceeds to Ryan's wife [R. T. 219-220].

IV. Appellant's Defense.

In his defense, Ryan admitted receipt of the \$700 but denied it was received for any illegal purpose [R. T. 661-662]. Appellant Ryan denied having anything to do with the three \$1500 checks from Ewins, the \$3725 check from Arlington Builders or the \$1687 check from Triangle Development [R. T. 664-665, 680, 690-692]. In addition, appellant denied being at the Valley National Bank on December 27, 1954 with Mrs. Owens, and denied receiving Exhibit 81, a \$1000 check from Eugene Shidler, a general contractor [R. T. 796].

In rebuttal, Les Allen, President of the Valley National Bank, testified that appellant was at such bank with Mrs. Owen on December 27, 1954 [R. T. 780]. Shidler testified he handed Exhibit 81, the \$1000 check, to Ryan [R. T. 789-790], and Mrs. Owens testified that this check was transmitted to her by a memorandum in appellant's handwriting [Ex. 87-B] enclosed in a letter written by Mrs. Ryan [R. T. 773].

Apparently the jury gave appellant's testimony the credence it deserved.

ARGUMENT.

The Jury Was Instructed Correctly That 18 U. S. C. §220 Was Violated by Receipt of Money Subsequent to a Loan.

Although the record [R. T. 933] discloses that no exception was taken to the following Instruction, appellant claims (Br. pp. 23-24) that the giving of this Instruction was error:

“You will have observed that the statute from which I have just quoted is clearly so worded that it does not limit its applicability to those instances in which an officer or employee of a bank, at a time before the procuring of or the endeavoring to procure, a loan in question, stipulates for or receives or consents or agrees to receive any fee, commission, gift, or thing of value from any person, firm or corporation, for procuring or endeavoring to procure such loan. What is vital and essential to guilt is that, in point of fact, the stipulation for, or receipt of, or consent or agreement to receive, any fee, commission, gift or thing of value from any person, firm or corporation actually be for the procuring of, or the endeavoring to procure, a loan from the bank either for such person, firm or corporation, or for any other person, firm or corporation. If that be true, then the conduct of the officer or employee involved is in violation of the statute quoted, even though the loan in question be made or approved before the date of such stipulation for, or receipt, or consent or agreement to receive the fee, commission, gift or other thing of value.” [R. T. 897-898].

Appellant argues that the error of the Instruction lies in the fact that the applicable statute, 18 U. S. C. Section 220, pertains only to situations where a fee or gift is received, or an agreement to so receive is made, prior to or during the procuring of the bank loan (Br. p. 24).

It may be of interest to this Court to read District Judge Delehant's comments regarding the instant problem. At the close of the plaintiff's evidence, the Court ruled:

"Now, as to the other counts at which the motion is aimed, I am aware, and have been as the evidence has been presented, of the contention which the defendant makes in a variety of ways.

First and with no little point, that in most, if not all—although I think not all—of the instances the loans mentioned were fait accompli before there was any changing hands of money.

I am of the opinion, after careful and repeated reading of the statute, that that does not defeat the prosecution. We are not dealing here with any question of the nicety and technicality of consideration and the like, that isn't at issue. The recognition either of an existing and subsisting engagement to pay, or, as counsel for the Government has said, the payment of an outright gratuity for services rendered, without any obligation or commitment, would, as I believe, if the matter be referrable to the procurement or endeavoring to procure a loan, be violative of the statute." [R. T. 573].

The District Court again passed upon this question in determining a Rule 29(b) motion. Although appellant has quoted a portion of the Court's observations, it might

be more fair to Judge Delehant to have his entire thought set forth:

“Now, if I be mistaken in my conclusions that once an officer or employee of a banking institution, whose deposits are secured by the Fidelity Deposit Insurance Corporation, has procured or caused the procurement of a loan by the bank to an individual, a firm or a corporation, the payment to him thereafter or the arrangement for payment to him thereafter of any sum of money—and we are dealing with money here, and I do not overlook the fact that the statute is aimed at other things—is not denounced by the statute, even though the payment made or contemplated be a reward for the action of the officer or the employee, then I was wrong in submitting the case to the jury.

But throughout the trial I have been persuaded and am persuaded that such a view of the statute is completely inadmissible and had been so inadmissible throughout. If such an amendment of the statute were to be made judicially, it would have to be made by appellate authority, and not by a trial judge. I feel constrained to administer the statute as it is drawn and as drawn I believe it denounces each transaction here before me, on the basis of the evidence submitted by the Government, which now, after being credited by the jury, seems to me to have risen to the stature of the facts.

Under all of the circumstances and in the light of the verdict, I believe that the motion is not well taken as to any one of the six several counts on which the case was submitted to the jury. . . .” [R. T. 958-959].

I.

**The Statute Clearly and Unequivocally Proscribes
Receipt of Fees for Loans, Whether Before or
After a Loan; Hence, Statutory Construction Is
Unnecessary.**

As stated in *Flora v. United States*, 357 U. S. 63, 65 (1958):

“In matters of statutory construction the duty of this Court is to give effect to the intent of Congress, and in doing so our first reference is of course to the literal meaning of words employed.”

Turning to the words employed in United States Code, Section 220, Title 18, the statute makes subject to punishment any bank officer who

“receives . . . any fee . . . *for* procuring or endeavoring to procure . . . any loan. . . .”
(Emphasis added.)

The preposition “for” in the statute is thought by appellee to be of significance, and is defined by Webster’s New Collegiate Dictionary, 2nd Ed. (1953), as being “that in consideration of which, in view of which, or with reference to which, anything is, is done or takes place” and as “indicating the cause, motive, or occasion of an act or condition.”

Thus, the literal, unambiguous words of the statute state that it is illegal for a bank officer to take a fee “with reference to” a bank loan. There is not a word used in the statute which indicates that the fee must take place either before or after the loan—hence receipt of a fee for a loan is proscribed whenever payment of the fee takes place.

Appellant, however, argues that the statute reads in the “prospective” (Br. p. 24), and further states that because the past tense is not used, the statute does not prohibit the receipt of post-loan fees (Br. p. 29).

Grammatically, though, the only tense used in the statute is in connection with the verb “receives,” which is in the present tense. Apparently appellant considers that the phrase “for procuring or endeavoring to procure . . . any loan . . .” is in the prospective, or future, tense. This cannot be true because the quoted phrase is a gerund phrase, more a noun than a verb, and therefore has no tense. (*Harbrace Handbook of English*, p. 51, 1953.) This can be seen perhaps more easily by way of illustration than by reference to grammar books.

The quoted gerund phrase in the following sentence may be used with a verb of any tense:

“Procuring or endeavoring to procure a loan” (is)
(was) (will be) (has been) (had been) (will have
been) declared illegal.

The gerund phrase in the example and in the statute thus will be compatible with whatever verb tense is chosen because it has no tense. Hence, the statute does not read in the “prospective.” Instead it punishes one who “receives” a fee for procuring a loan. The crime is complete at the time of receipt as long as the fee was paid “for” procuring a loan. The literal words of the statute clearly state, therefore, that fees “for” loans are prohibited, without reference to whichever takes precedence in time.

The meaning of the words of the statute being clear, the rule is as was stated in *United States v. Standard Brewery*, 251 U. S. 210, 217 (1920):

“Nothing is better settled than that in the construction of a law its meaning must first be sought

in the language employed. If that be plain, it is the duty of the courts to enforce the law as written, provided it be within the constitutional authority of the legislative body which passed it.”

Or, as this Court phrased the question in *N. L. R. B. v. Lewis*, 249 F. 2d 832, 835 (9 Cir. 1957):

“We start the journey, as with all statutes, by examining the literal wording of the section. The language of a statute is the best and most reliable index of its meaning. Where the language is clear and unequivocal it is determinative unless the literal language does not comport with the intent and objectives of the statute viewed as a whole.”

II.

Interpretation of the Statute Shows Congressional Intent to Proscribe Post-Loan Fees.

A. Purpose of the Statute Is to Prevent Excess Fees Being Charged the Public.

There is little help in the cases respecting judicial interpretation of Section 220 on the issue herein involved (see *Schooler v. United States*, 231 F. 2d 560 (8 Cir. 1956).) In a civil suit by shareholders of a bank to recover extraordinary fees made by Fleishhacker, the president of the bank, for procuring a loan, this Court in *Fleishhacker v. Blum*, 109 F. 2d 543 (9 Cir. 1940) held:

“It is a settled principle . . . that a bank officer who receives a bonus or other consideration for procuring a loan of the bank’s funds commits a breach of trust, and that the consideration so paid belongs to the bank and may be recovered by it.

* * * * *

In the discharge of his high trust the law holds a responsible agent such as Fleishhacker was to standards of probity and fidelity more lofty than those of 'the market place.' These high standards this court is not disposed to whittle down."

In that case, the illegal fees of Fleishhacker were received long after the loans had been procured by him, although Fleishhacker's agreement to receive the fees was made before the loans. Hence, this case is at least some support for the proposition that post-loan fees are illegal. In any event, the facts of the *Fleishhacker* case are on a par with those in Counts Four, Seven and Eight of the instant Indictment, where the agreement to receive \$4500 from Jack Ewins was made before the loan and the receipt of the \$4500 occurred thereafter [R. T. 100-104].

Although no case to appellee's knowledge has passed upon the precise purpose of Section 220, one case has passed upon a very analogous statute, 18 U. S. C. Section 221, which reads:

"Whoever, being an officer, director, attorney, or employee of a national farm loan association, a Federal land bank, or a joint-stock bank . . . is a beneficiary of or receives, directly or indirectly, any fee, commission, gift, or other consideration for or in connection with any transaction or business of such association or bank, other than the usual salary or director's fee paid to such officer, director, or employee thereof, and a reasonable fee paid by such association or bank to such officer, director, attorney, or employee for services rendered, shall be fined not more than \$5,000 or imprisoned not more than one year, or both."

The similarity of Section 221 to the present Section 220 is apparent. As appellant has observed, however, Section 220 has been amended. The original form of Section 220 was virtually identical with Section 221, as may be observed upon a comparison of the original:

“Other than the usual salary or director’s fee paid to any officer, director, or employee of a member bank and other than a reasonable fee paid by said bank to such officer, director, or employee for services rendered to such bank, no officer, director, employee, or attorney of a member bank shall be a beneficiary of or receive, directly or indirectly, any fee, commission, gift, or other consideration for or in connection with any transaction or business of the bank.” (38 Stat. 732.)

The present Section 220 limits prohibition of extraordinary fees to loans and other specified transactions rather than to any business of the bank, but otherwise its purpose seems not to have been changed by the amendment. The purpose of Section 221 was determined in the case of *Speeter v. United States*, 42 F. 2d 937, 941-942 (8 Cir. 1930) to be to prevent gouging of borrowers by bank officials:

“The act prohibits an officer or employee receiving for services rendered any compensation or consideration other than that paid him directly as salary or fees. It seems fairly clear that it was the purpose of this statute to protect the borrower from any charges in form of commissions or fees charged, levied, or exacted by officers or employees of the bank. . . . [I]t seems fairly clear that the statute is dealing with and refers to the business of the bank with its customers. As to this business, the officers

and employees are forbidden to receive anything, either from the bank or from anyone else in connection with a transaction between the bank and a third person, by way of compensation or reward, except their regular salary or fees. The statute was intended, we think, to prevent abuses of this sort. . . . [C]learly the statute would cover the receipt by an officer or employee of a commission, fee, or a consideration in addition to his salary or fee due him for any transaction between the bank and its patrons. . . .”

The purpose of Section 221 being to prevent abuses of this sort being perpetrated upon borrowers, it is not unlikely that such also was the purpose of Section 220. That such was the intent of Congress is somewhat buttressed by the avowed purpose of the Federal Reserve Act of 1913, of which Section 220 formed a part; that purpose was said to be, *inter alia*,

“to establish a more effective supervision of banking in the United States.” (38 Stat. 251.)

If the intent of Congress, even partially, be to prevent the public from being milked of excess loan fees by unscrupulous bankers, then it would seem to be of little importance whether the banker’s demand for extra compensation came before or after the loans were made. The evidence in the instant case indicates that construction loans are paid out in installments [R. T. 104, 116], and it is common knowledge that renewals are often sought regarding loans, as are subsequent loans. Thus there would appear to be practical reason enough for a borrower to comply with an extortionate demand by a banker even though the loan already had been approved.

B. Post-Loan Payments to Bankers Tend to Create Improvident Loans.

Appellant argues that since the intent of Congress must have been to eliminate improvident loans (Br. p. 26), a banker's receipt of money subsequent to a completed loan would not influence him; hence, post-loan fees are not proscribed by the statute because they have no tendency to make the banker grant improvident loans. Assuming the premise that the sole intent of Congress regarding Section 220 was to eliminate improvident bank loans, the Government respectfully disagrees with appellant's conclusion that post-loan fees or gifts do not tend towards the creation of such improvident loans.

First, the argument ignores the corrupting tendency of the payment upon subsequent loans. It is almost inconceivable that a banker who had received a payment following one loan to a borrower would not be influenced thereby when the borrower requested a subsequent loan. Appellant answers this (Br. p. 27) by saying that the "crime, if any, would be in connection with the subsequent loan only." This answer assumes the point in issue, *i.e.*, that no crime is committed when a loan, for which a fee or gift is paid, is uninfluenced by the payment. Moreover, the answer forgets that an essential element of Section 220 is that the payment be "for" a loan. In the above example, the procuring of an influenced, subsequent loan would not be a crime because the payment was not *for* that loan, but for the first loan.

Second, the argument ignores the possibility that a banker might be influenced in making a second loan by the thought that a second payment may result. Yet, since the corruption in this example originated with the first payment, it is seen that post-loan payments do tend towards creating influenced, possibly improvident, loans.

Thus Congress, by enacting a statute which plainly forbids all extraordinary fees and gifts, whether before or after the loan, and whether the loan was or was not influenced, has legislated against improvident loans. If Congress had desired, it could have made the “influencing” of the banker’s decision upon a loan an element of the crime, as in the bribery statute, 18 U. S. C., Section 202. This statute, a felony, punishes an official who

“receives any money . . . with intent to have
his decision or action . . . influenced thereby.
. . . .”

An example of legislation with intent to prohibit officials from receiving money in connection with their duties for any reason is 18 U. S. C., Section 1914. This misdemeanor statute punishes an official who

“receives any salary in connection with his services as such an official . . . from any source
other than the Government of the United States.
. . . .”

The instant misdemeanor statute, Section 220, does not require the element of “influence” and merely prohibits bankers from receiving payments in exchange for procuring loans. Appellee submits that such legislation directly tends to eliminate improvident loans even though the prohibition therein includes post-loan fees or gifts.

C. Congressional Prohibition of “Gifts” as Well as “Fees” and “Commissions” Further Shows Intent to Forbid Post-Loan Payments.

1. Normally, a fee or commission is arrived at as a result of a bargain made between parties. If a banker bargained with a borrower for the payment of a fee, it would seem natural that the banker’s decision as to procuring the loan usually would be influenced thereby.

On the other hand, a gift cannot have been as a result of a bargain. It is conceivable that a banker who received a subsequent gift for a completed loan would have been uninfluenced thereby; but since Congress forbids the receipt of a "gift," it should follow therefore that the influencing of a particular loan is not an element of the offense.

2. If a pre-loan payment were made to a banker *for* his procuring a loan, it seems likely that the payment is more in the nature of a fee; likewise, it seems natural that such a payment after the loan was made would be more in the nature of a gift. Since the statute proscribes gifts, it seems likely that Congress intended post-loan payments to be prohibited.

III.

Summary.

Both the literal words of the statute and an analysis of Congressional purpose demonstrate that Section 220 forbids the receipt of post-loan fees. Any other construction of the statute would distort the clearly expressed intent of Congress. As the Supreme Court stated in *Old Colony R. Co. v. Commissioner*, 284 U. S. 552, 560 (1932):

"The plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover."

Appellant, naturally enough, argues that this is a penal statute and should be construed narrowly. Dealing with a somewhat similar problem of statutory interpretation,

the Supreme Court in *Osaka Shosen Line v. United States*, 300 U. S. 98, 101 (1937), held:

“To say that the passenger has not been brought to the United States unless the intent was to leave him here, is not to construe the statute but to add an additional and qualifying term to its provisions. This we are not at liberty to do under the guise of construction, because, as this court has so often held, where the words are plain, there is no room for construction. . . .

It is urged that the statute is highly penal in character and should therefore be construed strictly. But the object of all construction, whether of penal or other statutes, is to ascertain the Legislative intent; and in penal statutes, as in those of a different character, ‘if the language be clear, it is conclusive.’ ”

Similarly, *United States v. Rayner*, 302 U. S. 540, 552 (1938) held:

“We are not unmindful of the salutary rule which requires strict construction of penal statutes. No rule of construction, however, requires that a penal statute be strained and distorted in order to exclude conduct clearly intended to be within its scope—nor does any rule require that the act be given the ‘narrowest meaning.’ It is sufficient if the words are given their fair meaning in accord with the evident intent of Congress.”

It Was Not Plain Error to Instruct the Jury That Actual Procurement of a Loan Was Unnecessary to Guilt.

Appellant urges (Br. pp. 33-36) that the following Instruction to the jury was error:

“ . . . It is not essential to conviction that the plaintiff prove that the defendant did actually procure or endeavor to procure the loan described. Evidence that he did actually procure or endeavor to procure such loan, if and to the extent that you find such evidence to exist, may indeed be considered by you as reflective of the defendant's object and purpose in his acts, if and to the extent that you find he performed any acts. But the defendant is not in this case charged with, or being prosecuted for, the procurement of, or the attempt to procure, any loan from Bank of America National Trust and Savings Association.”

I. The Instruction Is Correct.

The statute does not require that a loan be procured or that a banker have endeavored to procure a loan. What is necessary is that the banker receive or agree to receive a fee, commission or gift *as consideration for* procuring or endeavoring to procure a loan. For example, should a banker intend and agree to receive \$500 for procuring a loan, but intervening circumstances prevent his procuring the loan, the statute nevertheless would be violated. Thus the Instruction is correct.

II. No Exception Was Taken to the Instruction.

Rule 30, *Federal Rules of Criminal Procedure*, clearly states:

“No party may assign as error any portion of the charge or omission therefrom unless he objects thereto

before the jury retires to consider its verdict, stating distinctly the matter to which he objects and the grounds of his objection.”

After the District Court charged the jury, the following proceedings transpired:

“The Court: The jurors all having withdrawn from the courtroom, and being now beyond the possibility of observing anything which may transpire in the courtroom, the doors of the courtroom being now closed, the court addresses counsel and inquires of counsel whether there be exceptions to the charge, and first addresses counsel for the Government.

Mr. Bevan: No exceptions, your Honor.

The Court: Counsel for the defendant?

Mr. Youngblood: Merely for the record, your Honor, because I believe we have in substance covered this before, but on behalf of the defendant I wish exception noted with respect to the instruction by which the jury was instructed that they need not find that the evidence conforms in the exact amount as to Count Eighteen. Other than that I have no further objection, no further exception.” [R. T. 932-933].

III. Appellant Was Not Prejudicial by the Instruction.

No exception to the instant instruction having been taken, it cannot be made the subject of reversal unless it be plain error under Rule 52(b), F. R. Cr. P. To resolve the question of plain error, assuming, *arguendo*, that the Instruction was erroneous, it must be determined whether the appellant was prejudiced by the Instruction. Although the burden in this respect is upon appellant, appellee invites the Court’s attention to the following factors.

First, there is no contention made by appellant that the loans for which fees were given were not in fact completed. The evidence clearly showed as to each count that (a) a loan or loans as pleaded in the Information were made and (b) that appellant procured the loan or loans. As to Counts Two and Three, Exhibits 10, 11, 13 and 14 proved that loans were made as pleaded [R. T. 36-37, 401; 36-37, 401; 37, 402; 37-38, 403]. Exhibits 12 and 15 proved that Ryan procured the loans [R. T. 37, 69, 391; 38, 391]. As to Counts Four, Seven and Eight, Exhibit 18 proved that the loan was made [R. T. 70, 404], and Exhibit 17 proved that Ryan procured the loan [R. T. 39, 69, 390]. As to Count Eighteen, Exhibits 33 and 34 proved that the loan was made [R. T. 44, 408; 45, 77, 387], while Exhibit 32 proved that Ryan procured the loan [R. T. 44, 76-77, 387].

Since the evidence undeniably proved that the loans were made and that appellant procured them, there is no prejudice in inadvertently instructing the jury that the Government need not prove these facts.

Second, the erudite trial judge painstakingly instructed the jury as to the elements of the offense, including the element that the fee be for procuring a loan. The record discloses the following instructions:

“Each count of the information before you was prepared, made and filed under Title 18, United States Code, Section 220. By that section, so far as it is material for your purposes, it is provided that:

“ ‘Whoever, being an officer, or employee . . . of any bank, the deposits of which are insured by the Federal Deposit Insurance Corporation . . . except as provided by law, stipulates for or re-

ceives or consents or agrees to receive any fee, commission, gift, or thing of value, from any person, firm, or corporation, *for procuring or endeavoring to procure* for such person, firm, or corporation, or for any other person, firm, or corporation, from any such bank . . . *any loan . . . by any such bank . . . shall be . . .*’ [Tr. 896] (Emphasis added.)

guilty of a criminal offense.

“ . . . the statute undertakes, by the imposition of criminal sanctions against it, to prevent an officer or employee of such bank from stipulating for, or receiving, or consenting or agreeing to receive any fee, commission, gift, or thing of value, from any person, firm or corporation, *for procuring or endeavoring to procure from such bank any loan for* such person, firm or corporation, or for any other person, firm, or corporation” [T. R. 897] (Emphasis added.)

“ . . . What is vital and essential to guilt is that, in point of fact, the stipulation for, or receipt of, or consent or agreement to receive, any fee, commission, gift or thing of value from any person, firm or corporation actually be *for the procuring of, or the endeavoring to procure, a loan* from the bank either for such person, firm or corporation, or for any other person, firm or corporation” [T. R. 898] (Emphasis added.)

“ . . . Rather, the plaintiff must prove beyond a reasonable doubt that the defendant stipulated for, or received, or consented or agreed to receive, such fee, or commission, or gift, or thing of value *for procuring or endeavoring to procure* from his em-

ployer bank a loan for such borrower.” [T. R. 899].

“ . . . the essential elements of each such count which the plaintiff must prove beyond a reasonable doubt, before you may find the defendant guilty of the charge against him made in that count, may be summarized as follows:

* * * * *

“4. . . . That such stipulation for, or receipt, or consent or agreement of the defendant, if any, to receive such fee, commission, gift or thing of value was *in return for the defendant’s procuring or endeavoring to procure a loan from Bank of America . . .*” [T. R. 899, 900]. (Emphasis added.)

“ . . . But, here again, the statute from which I have quoted does not require the proof of both the procurement and the endeavor to procure such loan as the purpose of the defendant’s alleged acts but is satisfied by the proof of *either the procurement or the endeavor to procure such loan* as the purpose of the defendant’s alleged acts.” [T. R. 903] (Emphases added.)

Following these instructions, the Court then proceeds to instruct the jury upon the matter which appellant argues is erroneous. To be fair to the District Judge, appellee will set forth below the full and complete Instruction given the jury, because the portion thereof which appellant has selected to criticize should be taken in context:

“Let me explain to you another and somewhat related phase of the plaintiff’s charges against the defendant. To do this, I shall have to be somewhat

repetitious. In each count of the information, the plaintiff charges and alleges that the defendant stipulated for, received, consented and agreed to receive, a designated sum of money as a fee, commission, gift and other thing of value for procuring and endeavoring to procure a designated loan from Bank of America National Trust and Savings Association. What the plaintiff must prove in that behalf is, as I have already declared to you, that the defendant stipulated for, or received, or consented to receive, or agreed to receive the designated sum of money as a fee, or a commission, or a gift, or another thing of value *for procuring or endeavoring to procure the loan described*. It is not essential to conviction that the plaintiff prove that the defendant did actually procure or endeavor to procure the loan described. Evidence that he did actually procure or endeavor to procure such loan, if and to the extent that you find such evidence to exist, may indeed be considered by you as reflective of the defendant's object and purpose in his acts, if and to the extent that you find he performed any acts. But the defendant is not in this case charged with, or being prosecuted for, the procurement of, or the attempt to procure, any loan from Bank of America National Trust and Savings Association." [T. R. 903-904]. (Emphasis added).

It is obvious that the jury cannot have been misled by the Instruction of which appellant belatedly complains. Complete instructions upon the elements of the offense were given and it was undisputed in the lengthy (fourteen days) trial that the loans were made by the Bank of

America. Therefore, assuming, *arguendo*, that the Instruction was erroneous, it was not prejudicial to the appellant, and Rule 30 precludes appellant from raising the matter.

Conclusion.

The judgment should be affirmed.

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No. 16,491

IN THE

**United States Court of Appeals
For the Ninth Circuit**

S. B. HUFFMAN, Trustee of the Estate
of Newcomb Interests, Inc., a cor-
poration, doing business as Casa Del
Rey Hotel, Bankrupt,

Appellant,

vs.

HARRY A. FARROS,

Appellee.

APPELLANT'S OPENING BRIEF.

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U.S. COURT OF APPEALS

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Rey Hotel, Bankrupt,

Appellant,

vs.

HARRY A. FARROS,

Appellee.

APPELLANT'S OPENING BRIEF.

STATEMENT OF JURISDICTION.

The Referee in Bankruptcy on November 2, 1956, made and entered his Order Granting Trustee's Petition for Leave to Sell Personal Property Free and Clear of Liens (T.R. pp. 6-8) which Order was made in proceedings pending in the United States District Court for the Northern District of California, entitled "In the Matter of Newcomb Interests, Inc., a corporation, doing business as Casa Del Rey Hotel, Bankrupt", and numbered 44913 in the records and files of said Court. Appellee's Petition to have the

Order reviewed by the District Court was filed on December 5, 1956. (T.R. pp. 3-5.) The Petition was timely (11 U.S.C.A. 67c), and the District Court had jurisdiction to review the Order. (11 U.S.C.A. 67c.) In a memorandum and order made and entered on April 1, 1959, the District Court reversed the aforesaid Order of the Referee. (T.R. pp. 35-40.) Notice of appeal therefrom to this Court was filed May 7, 1959. (T.R. p. 41.) The appeal was timely. (11 U.S.C.A. 48.) The jurisdiction of this Court to review the memorandum and order is sustained by 11 U.S.C.A. 47.

STATEMENT OF QUESTION PRESENTED.

The question before the Court is:

Does the Appellee, who was the former owner of a liquor license, and who purported to lease the same along with the real property to the Bankrupt, have the right as against Appellant Trustee in Bankruptcy to reclaim the liquor license from the bankrupt estate?

SPECIFICATION OF ERROR.

The Appellant's Concise Statement of Points Urged on Appeal, filed herein (T.R. pp. 61-62) gives in detail the points relied upon by Appellant. They are as follows:

1. That said Order was not supported by the evidence and is contrary to the law in that:

(a) The holding by said District Judge that the liquor license could not be subject to any creditor's claim of lien is erroneous and contrary to law.

(b) The holding of the District Judge that the property held under trust cannot here be reached by the Trustee's creditors since the beneficiary did nothing to induce the Trustee's creditors to rely on the apparent worth of that title, is erroneous and contrary to law.

STATEMENT OF FACTS.

The facts as set forth in the Stipulation as to Facts filed in these proceedings (T.R. pp. 15-18) are as follows:

“That on July 25, 1946, Harry A. Farros, Michel Stamatopolous and Themis Stamatopolous, as Lessors, entered into a written lease agreement with the bankrupt, Newcomb Interests, Inc., as Lessee, for a term of fifteen years and one month, commencing on August 1, 1946, which lease was duly executed, acknowledged and recorded in the Office of the County Recorder of the County of Santa Cruz, State of California, on August 5, 1946. That thereafter Appellee Harry A. Farros, purchased all of the interest covered by the lease, both real and personal, from said Michel Stamatopolous and Themis Stamatopolous, and at all times herein mentioned was the sole owner of the property, both real and personal. That on the said 25th day of July, 1946, at the time of the execution of said lease, the said Lessors were the owners of the on-sale gen-

eral liquor license issued by the State Board of Equalization of California, and then in effect in the said demised premises, and as part of the transaction and the execution of said lease and without any additional consideration whatsoever from the Lessee therein to the said Lessors, the said Lessors transferred said on-sale general liquor license covering said premises to Newcomb Interests, Inc., the bankrupt. That in said lease in paragraph Twenty-Sixth thereof, it was specifically provided as follows:

‘Twenty-sixth: That the lessor has transferred to the lessee all liquor licenses covering the sale of liquor in the demised premises, and the lessee agrees that at the expiration of the term of this lease or of the renewal period thereof, if the same is renewed, the said lessee will transfer to said lessor, all liquor licenses covering said premises without any consideration whatsoever on the part of the lessor.’

“That the bankrupt Lessee defaulted in the performance of the lease agreement in failing to pay the rental due on the said lease commencing with the monthly installment due on the 1st day of August, 1954, and continuing to default at all times thereafter.

“That on the said 25th day of July, 1946, Section 7.3 of the Alcoholic Beverage Control Act had not been adopted and there was no regulation of the Board of Equalization of the State of California preventing the legal execution and enforcement of the provisions of paragraph Twenty-sixth of said lease hereinabove set out; that the said Section 7.3 did not

become effective until October 1, 1949, more than three (3) years following the execution of said lease.

“That as security for the payment of the rental under said lease, said bankrupt Lessee executed a chattel mortgage covering the personal property located in said hotel, which chattel mortgage was duly foreclosed by Appellee, Harry A. Farros, on September 30, 1954, at which time Appellee entered into possession of said hotel and has been in possession at all times since that date.

“That at the time of the filing of the original Petition in Bankruptcy herein on the 6th day of June, 1955, said On-Sale General Liquor License No. P-6259-C stood in the name of Newcomb Interests, Inc., a corporation doing business as Casa Del Rey Hotel, into which name it had been transferred by the Lessors on or about July 25, 1946, at the time of the execution of said lease and under the terms thereof.”

ARGUMENT.

I. THE LIQUOR LICENSE IS PROPERTY WHICH PASSED TO THE APPELLANT TRUSTEE IN BANKRUPTCY AND CAN BE REACHED BY THE BANKRUPT'S CREDITORS.

There is no possibility of dispute that a liquor license is property, title to which passes to the Trustee in Bankruptcy, and that it is so treated by the Courts of the State of California. *Roehm v. County of Orange*, 32 C. A. 2d 280, 187 P. 2d 49, by the United States District Court in the State of California; *In*

Re Quaker Room, 90 Fed. Supp. 758, and by this Court in *Citrigno v. Williams*, 255 F. 2d 675.

The Appellant Trustee in Bankruptcy acquires his right to the license from Section 7¹ of the Alcoholic Beverage Control Act as amended in 1947, Rule 60b of the Rules and Regulations of the State Board of Equalization and Section 70a (11 U.S.C. 110a) of the Bankruptcy Act.

Section 70a of the Bankruptcy Act vests in the Trustee title to all property of the bankrupt, which the bankrupt could, by *any means*, have transferred. Ruly 60b of the State Board of Equalization states that "a Trustee of the bankrupt estate of a *licensee* may execute a transfer application." It is conceded that the bankrupt was, at the time of the filing of the petition in bankruptcy, the licensee.

At the time of the filing of the petition in bankruptcy any creditors inquiring of the State Board and selling liquor or other merchandise to the bankrupt on credit would be entitled to rely on this ownership of record. Appellee clearly permitted the bankrupt to exercise dominion over the license and to use the same in the operation of the bankrupt's business.

Very pertinent is the opinion of the Supreme Court of the United States in *Benedict v. Ratner*, 268 U.S. 353, 69 L. Ed. 991, wherein, in discussing assignments of accounts receivable, the Court stated, at page 364:

"The results which flow from reserving dominion inconsistent with the effective disposition

¹Now Section 24071 of the Business and Professions Code of the State of California.

of title must be the same *whatever the nature of the property transferred*. The doctrine which imputes fraud where full dominion is reserved must apply to assignment of accounts although the doctrine of ostensible ownership does not . . . the assignment must be deemed fraudulent in law, if it is agreed that the assignor may use the proceeds as he sees fit.” (Italics ours.)

Where the consent of the State Board of Equalization was required to the transfer of the liquor license, the question of title cannot be separated from the provisions of the state law setting forth the manner in which the title must be transferred. See *England v. Nyhan*, (9th Cir.) 141 Fed. 2d 311, a case involving the transfer of a permit to operate taxicabs, where the Court stated, at page 313:

“But it is clear, and undisputed here, that at the time the petition in bankruptcy was filed the permit to operate the taxicabs was *in the name of the bankrupt and by the provisions of the local laws he was the only person able to operate the cabs under its sanction*. It is likewise clear that any attempted transfers made prior to the filing date were ineffectual and the appellee took nothing . . .” (Italics ours.)

In 1949 the Legislature of the State of California enacted Section 7.3 of the Alcoholic Beverage Control Act.² The Appellate Courts of the State of California

²“No licensee shall enter into any agreement wherein he pledges the transfer of his license as security for a loan or as security for the fulfillment of any agreement. Each application for the transfer of a license must be accompanied by or contain a statement verified by both the transferor and transferee specifi-

have held that Section 7.3 does not have a retroactive effect, *as between the parties to the transaction*. See *Campbell v. Bauer*, 104 C. A. 2d 740, 232 P. 2d 590; *Tognoli v. Taroli*, 127 C. A. 2d 426, 273 P. 2d 914; *Etchart v. Pyles*, 106 C. A. 2d 549, 553, 554, 235 P. 2d 427, 430; *Saso v. Furtado*, 104 C. A. 2d 759, 769, 232 P. 2d 583, 589.

In all of these cases the Court held that the failure to enforce the agreement would amount to a fraud, since the licensee would substantially gain by his misconduct. Here, however, the party claiming the ownership of the license against the Appellee is Appellant Trustee in Bankruptcy representing the Creditors of the licensee who did business with and extended credit to the licensee-bankrupt on the basis of his record ownership of the license. It was held *In the Matter of Norman A. Murphy, doing business as Murfee's, Bankrupt*,³ that *such creditors had no duty to look further than to the face of the license to determine whether or not the person with whom they were doing business was, in fact, the licensee*.

cally stating that the transfer application or proposed transfer is not made to satisfy the payment of a loan or to fulfill an agreement entered into more than ninety (90) days preceding the day on which the transfer application is filed with the board or to gain or establish a preference to or for any creditor of transferor or to defraud or injure any creditor of transferor. Said statement shall become part of the transfer application and any misrepresentations contained in said statement shall be considered the misrepresentation of a material fact." Effective October 1, 1949. (Now Section 24076 of the Business and Professions Code of the State of California.)

³United States District Court for the Northern District of California, Case No. 38370 (cited by the Referee in his Certificate, T.R. p. 25).

Under Section 2(z 1) (Now Section 23009 of the Business and Professions Code of the State of California) of the Alcoholic Beverage Control Act, a "licensee" is "any person holding a license issued by the Board," and Section 3 (now Section 23300 of the Business and Professions Code of the State of California) of the same Act, reads, in part, as follows:

"No person shall exercise the privilege or perform any act or acts which a licensee under this act may exercise or perform under the authority of a license issued under this act *unless such person is authorized to do so by a license duly issued pursuant to the provisions of this act.*" (Italics ours.)

and Section 7 (now Section 24070 of the Business and Professions Code of the State of California) of the Alcoholic Beverage Control Act makes a transfer of the license contingent upon approval of the State Board of Equalization (now the Department of Alcoholic Beverage Control), and the payment of a transfer fee. It is clear that at no time prior to the filing of the Petition in Bankruptcy herein had Appellee obtained the approval of the Alcoholic Beverage Control Board to a transfer to him of the license in question, nor had he paid the transfer fee. Therefore, he could not be considered as the owner of the license.

We will concede, for the purposes of argument, that *as between Appellee and the Bankrupt*, Appellee might be able to require a transfer of the license by means of a state court action; it is submitted, how-

ever, that, as against Appellant Trustee, the Appellee is not entitled to exercise any of the rights of ownership since the license was, at all times after July 25, 1956, in the name of and legally belonged to the bankrupt.

II. THE LIQUOR LICENSE IS PROPERTY SUBJECT TO A CREDITOR'S CLAIM OF LIEN.

The District Judge in his memorandum and order here appealed from, held that the liquor license could not have been subject to any creditor's claim. (T.R. p. 38.) Section 70a(5) 11 U.S.C.A. 110a(5) provides as follows:

"The trustee of the estate of a bankrupt and his successor or successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this Act, except insofar as it is to property which is held to be exempt, to all of the following kinds of property wherever located . . . (5) *property*, including rights of action, *which* prior to the filing of the petition *he could by any means have transferred* or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered . . ."

(Italics ours.)

and Section 70c of the Bankruptcy Act (U.S.C.A. 110c) provides:

"The trustee may have the benefit of all defenses available to the bankrupt as against third

parties, including statutes of limitation, statutes of frauds, usury, and other personal defenses; and a waiver of any such defense by the bankrupt after bankruptcy shall not bind the trustee. *The trustee, as to all property*, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date, *with all the rights, remedies and powers of a creditor then holding a lien thereon by such proceedings*, whether or not such a creditor actually exists.” (Italics ours.)

In *Golden v. State of California*, 133 Cal. App. 2d 640, 285 P. 2d 49 at 53, the Court held that the liquor license was property upon which the United States could and did acquire a lien, citing *In Re Quaker Room*, 90 Fed. Supp. 758, and decisions from other jurisdictions. In *United States v. Blackett*, 220 F. 2d 21, cited by the State Court in *Golden v. State of California*, supra, a creditor of Blackett obtained a judgment against Blackett, and after examination of Blackett in supplemental proceedings on the unsatisfied judgment, the liquor license was ordered sold by the Court, and the government levied upon the proceeds. This Court held that the government was entitled to the proceeds of the sale of the license, although finding that the government had not attempted to impose its lien against the license because of the facts of the case. However, in the *Golden* case, supra, the Appellate Court of the State of California, held

that *the government could obtain a lien on the license*, and this Court is bound to apply the law of the State of California. The state courts, not the federal courts, are the final arbiters of the state law, and this is true even though the announcement of state law is made by an intermediate state appellate court. *Six Companies of California v. Joint Highway District No. 13 of California*, 311 U. S. 180 (1940); *West v. American Telephone and Telegraph Co.*, 311 U.S. 223 (1940).

Since, under Section 70c of the Bankruptcy Act, *supra*, the Trustee is deemed to be vested with all of the rights, remedies and powers of a creditor then holding a lien in such proceeding, whether or not such a creditor exists, the District Court erred in finding that creditors and thus Appellant Trustee could not obtain a lien on the liquor license. This is true “*whether or not a creditor actually existed.*” See *Constance v. Harvey*, (2 Cir.) 215 F. 2d 571, cited with approval by this Court in *England v. Sanderson*, 236 F. 2d 641 at 643.

This question has also been effectively disposed of and all of the authorities on the subject are covered in the Opinion of the Attorney General of the State of California of June 9, 1959, numbered 59/40, which opinion is set forth, in full, in Appendix “A” hereof.

CONCLUSION.

In view of the facts and law hereinabove set forth, it is Appellant's contention that the provisions of Section 7.3 of the Alcoholic Beverage Control Act, do not apply as against Appellant; that the creditors of the bankrupt could have obtained a lien on the liquor license and that the liquor license is, therefore, properly an asset of the bankruptcy estate, and that Appellee cannot reclaim same and that the memorandum and order of the District Judge here complained of, should be, by this Court, reversed and remanded with instructions to the District Court to make and enter an order in said bankruptcy proceedings affirming the Referee's Order of November 2, 1956.

Dated, Burlingame, California,
August 31, 1959.

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(Appendices A and B Follow.)

Appendices.

Appendix A

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Opinion
of
Stanley Mosk,
Attorney General;
Walter J. Wiesner,
Deputy Attorney General.

No. 59/40

The Honorable Thomas W. Martin, Director of the Department of Alcoholic Beverage Control, has requested the opinion of this office on the following questions:

1. Are licenses issued by the department subject to attachment and execution?
2. If licenses issued by the department are subject to attachment and execution, what are the rights of a purchaser at an execution sale?

The conclusions may be summarized as follows:

Licenses issued by the Department of Alcoholic Beverage Control are subject to attachment and execution. The purchaser may request transfer of the license to himself or his transferee but the department retains the right to revoke or suspend the license if the licensee has engaged in conduct which would

justify a revocation or suspension and may exercise its discretion in determining whether or not to approve the transfer of the license to the purchaser or his transferee.

ANALYSIS

To determine whether a liquor license is subject to attachment and execution, it is necessary to ascertain the nature of the right created by the issuance of a license. Only "property" is subject to attachment and execution under sections 541 and 688 of the Code of Civil Procedure.

A liquor license is a unique thing. Article XX, section 22 of the California Constitution provides that the department has the power "in its discretion, to deny, suspend or revoke any" license if it determines that such action is desirable or necessary. Section 23300, Alcoholic Beverage Control Act, (hereinafter all section references are to the Business and Professions Code unless otherwise noted) provides that no person may exercise "the privilege" of engaging in an alcoholic beverage business without a license. And in a case where the rights of a licensee vis-a-vis the licensing agency were at issue, it was held that a license was a privilege and not property as that term is used in the due process clause of the Constitution. *State Bd. of Equalization v. Superior Ct.*, 5 Cal. App.2d 374.

It is common knowledge, however, that liquor licenses are bought and sold in the open market. (*Mollis v. Jiffy-Stitcher Co.*, 125 Cal. App.2d 236, 238).

For this reason the courts have, where the licensee and a party other than the licensing agency were involved, considered such licenses to be property. *Roehm v. County of Orange*, 32 Cal.2d 280; *Golden v. State of California*, 133 Cal. App.2d 640; and *In re Quaker Room*, 90 Fed. Supp. 758. In the *Roehm* case the California Supreme Court held that liquor licenses are not subject to ad valorem taxation as personal property because they are not included in the list of taxable intangibles specified in article XIII, section 14 of the California Constitution and section 111 of the Revenue and Taxation Code. Implicit in the opinion is the premise that liquor licenses are intangible property. In the *Golden* case, the court held that a license was property as that term is used in 26 U.S.C. sec. 3670, which gives the federal government a lien for taxes "upon all property and rights to property, whether real or personal, belonging to such person." And in the case of *In re Quaker Room*, the court held that a California liquor license was property as that term is used in the Bankruptcy Act. The court therein referred to the decisions refusing to classify a license as property for purposes of the due process clause as being a "characterization for . . . a limited purpose." The courts in the last two cases emphasized the fact that liquor licenses are transferable under the Alcoholic Beverage Control Act (secs. 24070 to 24076 Bus. & Prof. Code).

At least two courts in other jurisdictions have held transferable liquor licenses subject to attachment or execution. (*Rowe v. Colpoys*, 137 Fed.2d 249; 148

A.L.R. 488; and *Stallinger v. Goss* (Mont.), 193 Pac.2d 810.) In the *Rowe* case the court stated "No good reason, either of procedure or policy, has been urged, and none is apparent, for exempting this form of property right, and its tangible evidence, from the same process as that to which other property rights are subject. The appellate department of the Superior Court in San Diego County relied on these cases in holding that a liquor license was subject to execution in California. *Cross & Bates v. Blackett*, Unreported Memorandum Decision by Turrentine, P.J., San Diego County, Superior Court No. 158544. See, also the dissenting opinion in *Roehm v. County of Orange*, *supra*, and the discussion of this point in *Golden v. State of California*, *supra*, at 644 and 645.

In view of the above cases in which it was held or implied that a license is to be considered property in California where the licensing agency is not a party to the action, it must be concluded that liquor licenses are property as that term is used in sections 541 and 688 of the Code of Civil Procedure.

It has been contended however that even if liquor licenses are property, seizure and sale by a sheriff pursuant to a writ of execution are not permissible inasmuch as a transfer by sheriff's sale is not specifically authorized in sections 24070 through 24076.

Those sections do not support such a restrictive interpretation. Section 24070 provides that "Each license . . . is transferable *from* the licensee to another person" whereas section 24071 provides that a license "may be transferred *by or to*" certain named persons

and that with respect to such transfers the fee to be paid shall be substantially less than that provided for in section 24070. (Emphasis added.) Under section 24070 a license may be transferred “from” the licensee but need not be transferred “by” him. To qualify for the reduced transfer fee under section 24071, the transfer must be “by or to” one of the persons named therein. Thus it appears that licenses are made transferable by section 24070 and there is no necessity for a person to be listed in section 24071 before he may execute a transfer application.

In two cases, *Campbell v. Bauer*, 104 Cal. App.2d 740 and *Saso v. Furtado*, 104 Cal. App.2d 759, it was held that a court appointed commissioner could transfer a license though he is not specifically mentioned in the above sections. Although the court did not discuss the right of the commissioner to transfer the license, it stated, at page 770 in the *Saso* case, “The Board is required to recognize plaintiff as the transferee-applicant for a license, and the commissioner as the transferor.” Obviously the court did not believe that only licensees and those named in section 24071 could be transferors. (Cf. 14 Ops. Cal. Atty. Gen. 35 (1949).)

Section 24075, wherein transfers by certain named individuals including persons “acting in the legal or proper discharge of official duty” are exempted from the notice and escrow requirements of sections 24073 and 24074, also supports the broader interpretation. If only transfers by licensees and those mentioned in section 24071 had been contemplated,

there would have been no necessity for exempting transfers by the other persons named in section 24075. It should be noted that the court in the *Cross & Bates* case, *supra*, relied on this section in holding a license subject to execution. Nor is section 24076, which requires a statement by the transferor and transferee that the proposed transfer is not made to satisfy a loan or fulfill an agreement entered into more than 90 days prior to the filing of the transfer application, inconsistent therewith. In *Holt v. Morgan*, 128 Cal. App.2d 113, 116, the court stated that "the purpose and policy of the section is to prohibit all use of a liquor license as security." Though the coverage of the section is not limited to pledges of licenses (*Citrigno v. Williams*, 255 F.2d 675), it seems clear that it was not intended to prohibit execution sales.

Although it is concluded that the property interest of the licensee is subject to attachment and execution and the sheriff or the purchaser may transfer that interest, it should not be inferred that the purchaser may then commence selling alcoholic beverages. The purchase of the interest of the licensee does not carry with it the right to an automatic approval of the transfer of the license by the department. A license is transferable only "upon the approval of the department" (sec. 24070) and the department is required to exercise its discretion (art. XX, sec. 22, Calif. Const.). The department may refuse to renew "or transfer" any license where there are outstanding tax liabilities which arose in the operation of the licensed business (sec. 24049). Moreover, if the li-

censee has engaged in conduct which would justify the suspension or revocation of the license under sections 24200 or 24200.5, the license would remain subject to revocation or suspension. As the court pointed out in the *Saso* case, *supra*, 768, all transactions involving the transfer of a license must be considered as containing an implied condition "that the transfers must be subject to the approval of the [department] and subject to its rules."

* * * * *

Appendix B

TABLE OF EXHIBITS

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No. 16,491

IN THE

United States Court of Appeals
For the Ninth Circuit

S. B. HUFFMAN, Trustee of the Estate
of Newcomb Interests, Inc., a cor-
poration, doing business as Casa Del
Rey Hotel, Bankrupt,

Appellant,

VS.

HARRY A. FARROS,

Appellee.

BRIEF FOR APPELLEE.

A. DON DUNCAN,

16th Floor, De Young Building,
690 Market Street,
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FILED

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No. 16,491

IN THE

**United States Court of Appeals
For the Ninth Circuit**

S. B. HUFFMAN, Trustee of the Estate
of Newcomb Interests, Inc., a cor-
poration, doing business as Casa Del
Rey Hotel, Bankrupt,

Appellant,

VS.

HARRY A. FARROS,

Appellee.

BRIEF FOR APPELLEE.

STATEMENT OF THE CASE.

Appellant sets forth in his Opening Brief the "Stipulation As to Facts" entered into by the parties through their respective counsel (AOB 3), without the preamble thereto, which reads: "It is Hereby Stipulated . . . that the *following facts shall be considered* by the Court on the hearing of the Petition for Review." (TR 15.) Thus, the Stipulation covers *all* the facts to be considered by the Reviewing Court; it dis-

(NOTE): All emphasis will be appellee's unless otherwise noted. References to Appellant's Opening Brief will be, e.g. (AOB 10).

penses with the discussion of any other matters of evidence, and *excludes* from consideration any other alleged "facts"; except those stipulated to, except documentary facts which may appear from the record. 46 CalJur2d 14, Sec. 7; 46 CalJur2d 34, Sec. 15. The Stipulation As to Facts was practically the same as a "Settled Statement" of the evidence. 4 CalJur2d 118, Sec. 353.

Documentary facts, showing the basic proceedings, necessary to complete a statement of the case, are: Upon the Petition of the Trustee in Bankruptcy for an Order to sell the liquor license free and clear of any lien, claim, right or interest therein, of Harry Farros, appellee (TR 32), the Referee issued an Order directed to Harry Farros to show cause why the Order asked by the Trustee should not be granted (TR 34). Farros appeared and filed his Answer and Claim of Interest, claiming ownership of said liquor license, and that he was entitled to the transfer thereof to him, or to his nominee (TR 8), upon which a hearing was held. The Referee then entered his Order Granting the Petition of the Trustee to Sell Free and Clear of any lien, claim, right or interest in said liquor license of Harry Farros. (TR 6.) Thereupon Farros through his then counsel, filed his Petition for Review of said Order. (TR 3.) Thereupon, the Trustee, and Appellee, through their attorneys entered into a Stipulation (TR 13), which, after reciting the foregoing proceedings, provided: that the Trustee "may forthwith proceed to sell" the liquor license "*covering the premises* formerly occupied by said bankrupt", subject to the

approval of the Department of Alcoholic Beverage Control, at public sale, and that the “proceeds of said Trustee’s sale of said liquor license shall be impounded by said Trustee, and any and all claims of lien or interest or title which said Respondent (Harry Farros) may have had in or to or upon said liquor license, shall, for all purposes, be deemed transferred to the said *proceeds* of the said Trustee’s sale of said liquor license, without prejudice to any of the rights of said Respondent (Farros) in said liquor license, and without prejudice to the rights of the Trustee to contest the validity of said claims of said Respondent (Farros) therein.” (TR 14.)

Upon this Stipulation it was “so ordered” by the Referee. (TR 15.)

It appears from the Referee’s Certificate on Petition for Review of Referee’s Order, under “Preliminary Proceedings” (TR 20), that, following the foregoing Stipulation to the Sale of the license, same was sold at public sale by the Trustee, for \$6,000.00. Thus this is the monetary subject of this controversy.



THE THEORY OF THE HEARING BEFORE THE REFEREE AND THE BASIS OF HIS DECISION.

This was epitomized in the following quotation from the Referee’s Certificate On Petition for Review, under “Discussion” (TR 26), wherein, after quoting Section 7.3 of the *Alcoholic Beverage Control Act* (Now Sec. 24076 of the Business and Professions Code

of California, hereinafter referred to as "B & P Code"), effective *October 1, 1949*, then forbidding such retransfer agreements as the instant one (made on July 25, 1946), the Referee says:

"There is no question that Section 7.3 of the Alcoholic Beverage Control Act (Sec. 24076, B & P Code) hereinabove quoted was *aimed at* the lease agreement of August 1, 1946. (Exhibit No. 1.) * * *"

(In other words, that section 7.3—Sec. 24076, B & P Code—was retroactive, and invalidated the retransfer agreement contained in the lease.)

STATEMENT OF QUESTION INVOLVED.

Where the owner and operator of a hotel and bar therein, and a liquor license covering said bar, leases said hotel with bar, in July 1946, over three years prior to the effective date of Sec. 7.3 of the Alcoholic Beverage Control Act of California, which was October 1, 1949, which, as to agreements entered into *after* that date, would prohibit such retransfer agreements and invalidate them; and there is a covenant in said recorded lease providing, that said lessor has transferred to said lessee said liquor license (which transfer *to* lessee was without consideration), and that the lessee agrees that at the expiration of the term of said lease, it will retransfer to lessor said liquor license, without any consideration whatsoever on the part of lessor; and the lessee executes a chattel mortgage on the contents of the hotel with bar, coincident

with the lease, as security for payment of the rentals required thereunder; and the lessee defaults in such payments, and the lessor forecloses said chattel mortgage, and terminates and cancels said lease, and retakes possession of said hotel and bar; and some nine months thereafter, in June 1955, the lessee is adjudicated an involuntary bankrupt; can the trustee of lessee's estate in bankruptcy, legally, take possession of said liquor license as a purported asset of lessee's estate in bankruptcy, and sell same, free and clear of the claim of said lessor, to the ownership and possession of said liquor license, duly asserted in said bankruptcy proceedings; on the basis of the foregoing facts?

ARGUMENT.

- I. THE TRANSFER OF THE LICENSE TO LESSEE ON JULY 25, 1946, TO USE IN CONNECTION WITH THE HOTEL AND BAR THEN LEASED, AND THE PROVISION IN THE LEASE FOR RETRANSFER OF THE LICENSE TO LESSORS, UPON TERMINATION OF THE LEASE, WAS NOT AFFECTED BY THE PASSAGE OF SEC. 7.3 OF THE ALCOHOLIC BEVERAGE CONTROL ACT, EFFECTIVE OCTOBER 1, 1949, ASSUMING SUCH LEGISLATION PROHIBITED SUCH RETRANSFER AGREEMENTS. SUCH LEGISLATION WAS NOT RETROACTIVE. THE RETRANSFER AGREEMENT WAS VALID AND ENFORCEABLE.

Citrigno v. Williams, (May 1958) 255 F2d 675, 678, 679 (CCA 9th); *Cavalli v. Macaire*, (Apr. 1958) 159 CA2d 714, 324 P2d 336; *Tognoli v. Taroli*, (Sep. 1954) 127 CA2d 426, 273 P2d 914; *Pehau v. Stewart*, (Jun. 1952) 112 CA2d 90, 245 P2d 692; *Etchart v. Pyles*, (Sep. 1951) 106 CA2d 549, 553, 554, 235 P2d 427,

430; *Campbell v. Bauer*, (Jun. 14, 1951) 104 CA2d 740, 232 P2d 590; *Saso v. Furtado*, (Jun. 14, 1951) 104 CA2d 759, 769, 232 P2d 583, 589.

The basic holding of all these cases is in accord with the above heading. However, in *Citrigno v. Williams*, *supra*, decided by this court; while this rule is recognized therein as being the established rule of the decisions of the California courts, (255 F2d 679), it is held that the parties in *Citrigno v. Williams*, made so many changes and additions and amendments, in and to the *original* lease made *before* the effective date of *Sec. 7.3*, that the *final* lease agreement consummated *after* the effective date of said section, was actually a *new lease*, and being made after such effective date of the section prohibiting such retransfer agreements, it was subject to the inhibition of said section, and for this reason was invalid and unenforceable.

It is pointed out in *Cavalli v. Macaire*, *supra*, (159 CA2d 718):

“This section (7.3) is not only not retroactive as to rights that have accrued and have been adjudicated before the effective date of the section, but is also not retroactive as to rights that have accrued but have not yet been adjudicated. (*Tognoli v. Taroli*, 127 CA2d 426, 273 P2d 914.) . . .”

(And in quoting with approval from the opinion of the trial judge) (p. 720):

“... it is also beyond dispute that, at the time of the execution of each of the three documents above referred to (the leases, with agreement to retransfer the liquor license) it was the intention of all parties that defendants would merely have

the right to use said licenses until the premises were restored . . . Defendants have shown no equities, and, in our opinion, it would be unjust enrichment to hold that they were entitled to retain the licenses.”

In *Campbell v. Bauer*, supra, (104 CA2d 744) the court holds that:

“... to permit defendants to retain the advantage of their own wrong (refusal to retransfer the liquor license as agreed) would be unconscionable.”

In each of these cases (excepting *Citrigno v. Williams*, supra, for the reasons noted), it was held that the retransfer agreement was valid and enforceable.

In *Cavalli v. Macaire*, supra (159 CA2d 717), the court rendered judgment for lessor, that the defendants, lessees, were bound by the retransfer agreement and enjoined them from transferring the licenses to anyone but plaintiffs, and retained jurisdiction to make further orders to enforce the agreement of retransfer.

In *Tognoli v. Taroli*, supra (127 CA2d 427), the lessee having sold the license to another in violation of the retransfer agreement, without the knowledge of lessor, the court ordered judgment for its value, \$7,350.00.

In *Pehau v. Stewart*, supra (112 CA2d 97), the Judgment ordered appellants, lessees, to retransfer the liquor license to lessor in accordance with the terms of the lease. A *limited* new trial had been

granted but such order did not affect the Judgment as to the retransfer of the license.

In *Etchart v. Pyles*, supra (106 CA2d 553), the court entered a decree, ordering the defendant lessee to specifically perform the agreement in the lease for retransfer of the license to lessor.

In *Campbell v. Bauer*, supra (104 CA2d 742), while the transfer to defendants and their agreement to retransfer the license to plaintiffs, was made in connection with a loan to defendants and not a lease, the defendants refused to retransfer the license, upon default, and demand, as agreed in the contract. The court entered judgment that defendants *had no interest in the license*; restrained defendants from transferring the license to others than plaintiffs, and ordered defendants to execute such applications and instruments as might be necessary to effectively transfer the license to plaintiffs; and appointed a commissioner to execute the same in the event defendants refused to do so.

In *Saso v. Furtado*, supra (104 CA2d 761), there was the usual transfer by the lessor of the license to the lessee coincident with the making of the lease; and the usual agreement in the lease that lessee would retransfer the license to the lessor at the expiration of the lease, without consideration. When the lease expired the defendants refused to surrender the premises or to retransfer the license to plaintiff. The judgment in lessor's action was that defendant lessee execute an application for the transfer of the license

to plaintiff lessor, and she was enjoined from attempting to transfer same to anyone but plaintiff; and a commissioner was appointed to execute the application in the event defendant failed to do so.

II. A LIQUOR LICENSE IS A "PRIVILEGE", A "PERMIT". IT IS NOT A "PROPRIETARY RIGHT". IT IS INTANGIBLE PERSONAL PROPERTY NOT CAPABLE OF MANUAL DELIVERY, AND HENCE MAY NOT BE THE SUBJECT OF A CHATTEL MORTGAGE. IT IS A VALUABLE PROPERTY RIGHT, OWNED PRIVATELY AS PROPERTY IS OWNED. IT MAY BE TRANSFERRED AND IT MAY BE SOLD, SUBJECT TO THE APPROVAL OF THE STATE BOARD OF EQUALIZATION. IT IS NOT TAXABLE AS "PERSONAL PROPERTY" BY THE STATE, BUT IT IS SUBJECT TO U. S. INTERNAL REVENUE TAX.

Saso v. Furtado, supra (June 1951), 104 CA2d 759, 763, 232 P2d 583; *In Re Quaker Room* (May 1950), 90 F. Supp. 758, 761; *Golden v. State of California*, (June 1955), 133 CA2d 640, 643, 285 P2d 49; *Etchart v. Pyles*, supra (Sept. 1951), 106 CA2d 549, 551, 235 P2d 427; *Roehm v. County of Orange* (1948), 32 C2d 280, 290, 187 P2d 49.

In Re Quaker Room, supra, cited by appellant, (AOB 6, 11) holds (90 F. Supp. 761), that a liquor license, "constitutes 'property' as that term is used in the Bankruptcy Act." (Page 761.) But it does not hold that title thereto "passes to the Trustee in Bankruptcy", as claimed by appellant (AOB 6), nor that title should, or did, so pass in that particular case.

Golden v. State of California, supra (1955), 133 CA2d 643, cited by appellant (AOB 11), holds that for federal taxing purposes, "property" was used in a broad, not narrow, sense; and that a liquor license was subject to a lien for U. S. Internal Revenue Taxes. Otherwise the case is not in point.

Roehm v. County of Orange, supra (1948), 32 C2d 280, 290, cited by appellant (AOB 5), establishes and/or confirms, that a liquor license is intangible personal property, and as such is not subject to taxation by the State of California, as personal property, although certain intangibles specified by the court are taxable as personal property. That case involved solely such a taxing problem, has no other application to this case, and does not hold that a liquor license "is property, title to which passes to the Trustee in Bankruptcy" (AOB 5), as claimed by appellant, nor does it mention "bankruptcy."

III. UPON THE TERMINATION OF THE LEASE OF NEWCOMB INTERESTS, INC. (TR 17-IV) IT WAS OBLIGATED TO RE-TRANSFER THE LICENSE TO APPELLEE AS AGREED IN THE LEASE; ITS FAILURE TO DO SO WAS WRONGFUL; AND IT THEREUPON BECAME AN INVOLUNTARY TRUSTEE THEREOF FOR APPELLEE, THE OWNER OF THE LICENSE; AND HELD THE LICENSE IN ITS NAME AT THE TIME OF THE FILING OF THE PETITION FOR ADJUDICATION OF BANKRUPTCY AGAINST IT, AS SUCH TRUSTEE FOR APPELLEE.

Sec. 2223 *Civil Code* provides:

"One who wrongfully detains a thing is an involuntary trustee thereof, for the benefit of the owner."

Sec. 2224 *Civil Code* provides:

“One who gains a thing by fraud, accident, mistake, undue influence, the violation of a trust, or other wrongful act is, unless he has some other or better right thereto, an involuntary trustee of the thing gained, for the benefit of the person who would otherwise have had it.”

A liquor license authorizes the person to whom issued to exercise the rights and privileges specified therein “*at the premises for which issued* during the year for which issued.” Sec. 23355 *Business and Professions Code*. The whole transaction herein establishes that it was the intention of the parties to said lease that lessee would merely have the right to use said license until the premises were restored. *Cavalli v. Macaire*, supra, 159 CA2d 718. “While a liquor license must be renewed yearly and the license issued is a separate document from that issued the year before, it is considered the same license.” *Saso v. Furtado*, supra, 104 CA2d 762.

In *Church v. Bailey* (1949), 90 CA2d 501, 503, 203 P2d 547, cited in the decision of the U. S. District Judge writing the opinion herein, 171 F. Supp. 704, it is held, that an employee who misappropriated funds of his employer was chargeable as an involuntary trustee thereof for the benefit of the owner, under the aforesaid sections, and that a trust would be impressed upon property acquired with such funds unless the same is held by a bona fide purchaser for value without notice in good faith. Citing also Sec. 2243 *Civil Code*.

In *Hansen v. Bear Film Company, Inc.* (1946), 28 C2d 154, 169, 168 P2d 946, where trustor under an express trust, transferred the bare legal title of corporate stock to his mother as trustee to be transferred back to trustor at his request, and the latter did not demand a retransfer during his lifetime; it was held that upon trustor's death it was trustee's duty to immediately convey title to the stock into trustor's name or that of the representative of his estate, since upon trustor's death the express trust failed and the trustee then held the stock upon a resulting trust for trustor's estate.

It is said in *Fleishman v. Blechman* (1957), 148 CA2d 88, 93, 306 P2d 548, that a constructive or resulting trust, is a remedial device created to prevent unjust enrichment.

In *Niles v. Rapoport & Sons* (1942), 53 CA2d 644, 128 P2d 50 (also cited in the decision of the U. S. District Court herein, 171 F. Supp. 704), wherein the holders of a note of a third person agreed orally that they would hold the note for themselves and an attorney and collect the payments thereon and pay to said attorney one-half thereof, and then repudiated any interest of said attorney in the note or its proceeds and refused to comply with their agreement, it was held that the facts established against the holders of the note an involuntary or constructive trust, and that they must be held to hold the note and the attorney's interest therein as involuntary or constructive trustees for said attorney (suing through his assignee).

In *Monica v. Pelicas* (1955), 131 CA2d 700, 704, 281 P2d 357, wherein plaintiff's money was taken by defendant Arminda out of their joint account, and used for a purchase of real property in her name and that of Manuel, whereas plaintiff had authorized her only to buy property at the request of, and for Manuel, and put it in his name, it was held that under Sec. 2224 Civil Code, Manuel and Arminda became involuntary trustees of said property for the benefit of plaintiff who would otherwise have had it, and the court imposed such involuntary trust on the property itself. The court therein quotes the following from *Bainbridge v. Stoner*, 16 C2d 423, 428, 429:

“The theory of a constructive trust was adopted by equity as a remedy to compel one to restore property to which he is not justly entitled, to another . . . But the one whose property has been taken from him is not relegated to a personal claim against the wrongdoer which might have to be shared with other creditors; he is given a right to the restoration of the property itself. The title holder, is, therefore said to be a constructive trustee holding title to the property for the benefit of the rightful owner . . .”

To the same effect as the foregoing cases, is *Robertson v. Summeril*, (1940), 39 CA2d 62, 65.

A constructive trust is always an involuntary trust. 48 CalJur2d 657; *Norton v. Bassett*, 154 C 411, 97 P 894.

In the *Restatement*, on *Restitution*, p. 640, Sec. 160, it is set forth:

“Where a person holding title to property is subject to an equitable duty to convey it to another on the ground that he would be unjustly enriched if he were permitted to retain it, a constructive trust arises.”

IV. “EVERY ONE TO WHOM PROPERTY IS TRANSFERRED IN VIOLATION OF A TRUST, HOLDS THE SAME AS AN INVOLUNTARY TRUSTEE UNDER SUCH TRUST, UNLESS HE PURCHASED IT IN GOOD FAITH, AND FOR A VALUABLE CONSIDERATION.”

Sec. 2243 *Civil Code*. This section makes available against a transferee, other than an innocent purchaser for value, the option of having the property with its fruits replaced or of recovering the proceeds with interest. 49 *CalJur2d* 320, Sec. 467. (Auth.)

One who takes title from a trustee with notice of his relation, or knowledge of the facts, stands in his shoes, and takes title charged with all the rights, liabilities and duties that rested on his grantor at the time of the transfer. The trust is enforceable against him in the same manner and with like effect as against the original trustee. 49 *CalJur2d* 321, Sec. 468. (Auths.)

V. THE CLASSES OF PROPERTY WHICH PASS TO THE TRUSTEE IN BANKRUPTCY ARE GOVERNED PRIMARILY BY THE FEDERAL BANKRUPTCY ACT, BUT IN DETERMINING WHETHER PROPERTY OF THE BANKRUPT MIGHT HAVE BEEN TRANSFERRED BY HIM OR LEVIED UPON AND SOLD UNDER JUDICIAL PROCESS AGAINST HIM, THE LAWS OF THE STATE IN WHICH THE PROPERTY IS LOCATED, GOVERN.

8 *C.J.S.* 621, Sec. 169 on "Bankruptcy" (Auths.); *In re Waite-Robbins Motor Co.* (D.C.Mass.1911), 192 F. 47.

VI. THE BANKRUPT LESSEE COULD NOT CLAIM ANY RIGHT, TITLE OR INTEREST IN OR TO THE LICENSE, AND HELD SAME AS AN INVOLUNTARY TRUSTEE FOR APPELLEE. THE TRUSTEE OF ITS ESTATE IN BANKRUPTCY, THE APPELLANT HEREIN, IS IN NO STRONGER POSITION THAN THE BANKRUPT ITSELF WOULD HAVE BEEN TO RESIST AN APPLICATION TO RECLAIM PROPERTY HELD IN TRUST FOR THE RECLAIMANT, AND CANNOT SUCCESSFULLY DO SO.

TITLE ACQUIRED BY TRUSTEE.

"The trustee in bankruptcy does not acquire title to property the legal title to which is in the bankrupt as trustee, 74 (Many authorities cited) the trustee in bankruptcy is not entitled to property in the possession of the bankrupt which is held under an implied trust, or to which a constructive trust attaches, 76 (Many authorities)."

8 *C.J.S.* 653, Sec. 193 on Bankruptcy.

"The trustee in bankruptcy succeeds to the bankrupt's title and to all the rights and remedies pertaining thereto which the bankrupt could have exercised but for his bankruptcy. . . . Except

in so far as the trustee is subrogated to the rights of creditors which exceed as to the particular property the rights of the bankrupt, the trustee has no superior rights or greater interest in the property and occupies no better position with respect thereto than the bankrupt, 43 (Many cases cited) and he takes the property not as an innocent purchaser for value, without notice, but as the debtor had it at the time of bankruptcy, subject to all valid claims, liens and equities. 44. (Many auths.)”

8 *C.J.S.* 664, Sec. 199.

A resulting trust which might be established against the bankrupt may ordinarily be established against the trustee in bankruptcy. *In re Meyerfeld* (D.C.Cal.), 46 F2d 665, Affd. C.C.A. *Williams v. Levy*, 54 F2d 18.

“The Bankruptcy Act can give the trustee no greater rights than he would have under state law.”

8 *C.J.S.* 668, Sec. 199.

“Where the bankrupt holds property in trust for the benefit of another, equitable title is in such other notwithstanding legal title is in the trustee, and it is very doubtful whether any title whatsoever vests in the bankruptcy trustee as the bankruptcy court is a court of equity dealing primarily in the equities of the situation, . . . such court will recognize and give force and effect to resulting and constructive trusts in property held by the bankrupt, and even to obligations in the nature of a trust . . . Whatever obligations of this kind at-

tach to property coming to the hands of the bankruptcy trustee are good as against him and must be observed.”

Remington on Bankruptcy, 1957 Rev. Vol. 3,
Sec. 1417.

VII. THE BANKRUPT LESSEE WAS ESTOPPED TO ASSERT OWNERSHIP OR TITLE OR ANY INTEREST IN OR TO THE LIQUOR LICENSE AT THE TIME OF THE FILING OF THE BANKRUPTCY PETITION AGAINST IT, BY THE CIRCUMSTANCES UNDER WHICH THE LICENSE WAS TRANSFERRED TO IT BY APPELLEE, AND BY ITS WRITTEN AGREEMENT TO RETRANSFER SAME TO APPELLEE UPON THE TERMINATION OF ITS LEASE; AND ITS TRUSTEE IN BANKRUPTCY, APPELLANT, IS IN NO BETTER POSITION, AND LIKEWISE ESTOPPED.

Remington on Bankruptcy, 1957 Rev. Vol. 3,
p. 341, Sec. 1415.

VIII. WHERE PROPERTY STANDING IN THE NAME OF A DEBTOR IS SUBJECT TO A TRUST, THE DEBTOR HAVING MERELY THE BARE LEGAL TITLE, THE CREDITORS OF THE TRUSTEE CANNOT SUBJECT THE PROPERTY TO THE PAYMENT OF THEIR CLAIMS. THE LIEN OF THEIR JUDGMENT DOES NOT ATTACH TO THE LEGAL TITLE, AS IT IS A LIEN ONLY ON THE INTEREST OF THE JUDGMENT DEBTOR. LATENT EQUITIES AGAINST THE DEBTOR, SUCH AS ARISE UPON A TRUST, MAY BE ASSERTED AGAINST THE TRUSTEE'S ATTACHMENT OR JUDGMENT CREDITOR, WHO AS TO SUCH EQUITIES, DOES NOT HAVE THE STATUS OF A BONA FIDE PURCHASER FOR VALUE. AND THE RIGHTS OF THE EQUITABLE OWNER ARE UNAFFECTED BY THE INSOLVENCY OF THE TRUSTEE.

25 *CalJur* 210, Sec. 77; *McGee v. Allen* (1936), 7 C2d 468, 473, 60 P2d 1026; *Murphy v. Clayton* (1896),

113 C 153, 157 to 162, inc., 45 P 267; *Nishi v. Downing* (1937), 21 CA2d 1, 3, 67 P2d 1057; *Riverdale Min. Co. v. Wicks*, 14 CA 526, 112 P 896.

“If it can be established that property which stands in the name of a debtor is subject to a trust, the debtor having merely the bare legal title, the creditors of the trustee cannot subject the property to payment of their claims . . . the rights of the equitable owner are unaffected by the insolvency of the trustee.”

25 *CalJur* 210, Sec. 77.

“(EFFECT OF INSOLVENCY.) Although a trustee becomes insolvent or bankrupt, the beneficiary retains his interest in the subject matter of the trust if it can be identified, or in its product if it can be traced into a product, and is entitled thereto as against the general creditors of the trustee (see Sec. 202).”

Restatement—Trusts, Sec. 12, p. 42.

“KNOWLEDGE OF CREDITOR AS TO EQUITABLE OWNERSHIP. Nor is the trustee’s creditor in the situation of one who has acquired title to the property from the trustee without knowledge or notice of the beneficiary’s claim to equitable ownership. While a person who has dealt with another, relying upon the latter’s possession and apparent ownership of property, is protected in some situations, a mere extension of credit, as contradistinguished from a payment of a valuable consideration, does not, apparently, give rise to a right which is superior to that of the equitable owner.”

25 *CalJur* 213, Sec. 80, citing *Murphy v. Clayton*, 113 Cal 153, 159.

“RIGHTS OF TRANSFEREE AND EQUITABLE OWNER. If the property or money has passed from the trustee into the possession of a third person, the latter may be held liable at the suit of the equitable owner—provided that the defendant was not a taker for *value* and *without knowledge* of the trust . . .”

25 *CalJur* 214, Sec. 81.

“EFFECT OF KNOWLEDGE. On the other hand, a person who acquires property from another *with knowledge* that the transferror has merely the legal title, equitable ownership being in a third person, is deemed to hold the land, goods or securities charged with a trust in favor of the equitable owner . . .”

25 *CalJur* 222, Sec. 90.

“TIME OF ENJOYMENT. If a present beneficial ownership was created by a declaration of trust, or if title passed to trustees by a conveyance or transfer of the property, the validity of the trust is not affected by the circumstance that the beneficiary’s enjoyment of the property is postponed until a future time. In short, future trust estates or interests are valid. . . . The estate or interest which precedes that of the beneficiary *remains in the trustor.*”

25 *CalJur* 316, Sec. 167.

IX. BEFORE CREDITORS OF THE RECORD TITLE HOLDER CAN SUBJECT THE PROPERTY OF THE INVOLUNTARY OR CONSTRUCTIVE TRUSTEE TO PAYMENT OF HIS DEBTS, THEY MUST SHOW THAT THE RIGHTFUL OWNER KNEW THAT THE RECORD OWNER WAS CLAIMING THE PROPERTY AS HIS OWN AND THAT A CREDITOR WAS INDUCED TO EXTEND CREDIT IN RELIANCE ON THAT CLAIM.

48 *CalJur* 2d 754, Sec. 113, citing *In re Rogal*, 112 F. Supp. 712.

Though a deceased trustee's apparent ownership of the trust property may have given him a fictitious credit, the general creditors of his estate have no equities superior to those of the beneficiaries. *Byrne v. McGrath*, 130 C 316, 62 P 559.

A bankrupt trustee may continue to discharge his duties as a trustee, and the trust property in his possession does not go to his assignee or to his creditors. 48 *CalJur* 2d 754, citing *Bank of Cottonwood v. Henriques*, 91 CA 88, 266 Pac 836. Moreover, where there are no innocent transferees, and the beneficial owner has not knowingly permitted the legal owner to obtain credit by representing himself to be the true owner, property held by a bankrupt as trustee of a resulting trust is not subject to sale as property of the bankrupt estate. 48 *CalJur* 2d 754, Sec. 113, citing *Williams v. Levy*, 54 F2d 18.

X. WHO ARE BONA FIDE PURCHASERS.

One who purchases trust property for value from the holder of the legal title *without notice* of the trust is protected against enforcement of the trust. 49 *Cal*

Jur 2d 326, Sec. 473. But, an attachment or judgment creditor is not a bona fide purchaser for value, as against the owner of the equitable title or the one entitled to the subject of the trust.

49 *CalJur* 2d 327, Sec. 473;

McGee v. Allen, 7 C2d 468, 60 P2d 1026.

Nor is the trustee's trustee in bankruptcy a bona fide purchaser for value; 49 *CalJur* 2d 327, Sec. 473; *In re Rogal*, 112 F. Supp. 712; as he comes into them merely by operation of law.

Remington on Bankruptcy, 1957 Rev., Vol. 4, p. 486, Sec. 1741.

XI. NO CREDITOR OF THE LESSEE-BANKRUPT COULD CLAIM HE WAS "WITHOUT NOTICE" OF THE BENEFICIAL INTEREST OF APPELLEE IN THE LICENSE, FOR THE REASON THAT APPELLEE RECORDED THE LEASE AGREEMENT IN THE COUNTY RECORDER'S OFFICE IN SANTA CRUZ COUNTY WHEREIN THE LEASED PROPERTY WAS SITUATE, SHOWING THE TRANSFER OF THE LICENSE TO LESSEE AND ITS AGREEMENT TO RETRANSFER SAME TO APPELLEE. THIS GAVE PUBLIC NOTICE TO ALL INTERESTED, OF THE INTEREST OF APPELLEE IN AND TO SAID LICENSE.

(TR 15.)

Sec. 19 *Civil Code*; Sec. 1213 *Civil Code* provides:

"Every conveyance of real property acknowledged or proved and certified and recorded as prescribed by law from the time it is filed with the recorder for record is constructive notice of the contents thereof to subsequent purchasers and mortgagees; . . ."

Constructive notice of trust deed is binding in same manner as actual notice. *Central Const. Co. v. Hartman* (1935), 7 CA2d 702, 47 P2d 484.

Notice or imputed knowledge is predicable of matters appearing in public records. 25 *CalJur* 224; 36 *CalJur* 2d 415-417, Sec. 5.

The Lease Agreement was so recorded on August 5, 1946 (TR 15, Sec. I) about nine years before the filing of the Petition in Bankruptcy against lessee, showing the transfer of the license to lessee, and the latter's agreement in Par. 26th thereof, to retransfer same to lessor upon termination of the lease, without any consideration.

XII. NO CREDITOR OF THE LESSEE COULD HAVE BECOME A BONA FIDE PURCHASER OF THE LICENSE FOR VALUE AND WITHOUT NOTICE OF THE WRITTEN AGREEMENT OF LESSEE TO RETRANSFER SAME TO APPELLEE, NOR COULD ANY CREDITOR OF LESSEE-BANKRUPT HAVE BECOME AN ATTACHMENT AND EXECUTION CREDITOR OF LESSEE BASED UPON AN ALLEGED EXTENSION OF CREDIT TO LESSEE ON THE ALLEGED GROUND THAT THE LICENSE STOOD IN THE NAME OF LESSEE. AND THE LESSEE'S TRUSTEE IN BANKRUPTCY DOES NOT TAKE TITLE AS A BONA FIDE PURCHASER FOR VALUE WITHOUT NOTICE OF EQUITIES. HE DOES NOT HAVE THAT STATUS. HENCE IF HE TAKES ANY TITLE AT ALL AS SUCH TRUSTEE IT IS SUBJECT TO THE OWNERSHIP OF THE LICENSE BY APPELLEE, AND IN ANY EVENT ANY RIGHTS OF THE TRUSTEE IN BANKRUPTCY IN OR TO THE LICENSE WOULD BE SUBORDINATE TO THOSE OF APPELLEE AND IT IS THE DUTY OF SAID TRUSTEE TO SURRENDER TO APPELLEE THE PROCEEDS OF THE SALE OF SAID LICENSE. NO RIGHT, TITLE OR INTEREST IN OR TO THE LICENSE WAS VESTED IN LESSEE'S TRUSTEE IN BANKRUPTCY.

XII. A. Answer to Appellant's Contentions Directed Toward This Point.

Appellant makes the following statements:

(AOB 6) "It is conceded that the bankrupt was, at the time of the filing of the petition in bankruptcy, the licensee."

The stipulation is that at that time, the license "*stood in the name of Newcomb Interests, Inc. . . .*"

(AOB 6) "*At the time of the filing of the petition in bankruptcy any creditors inquiring of the State Board and selling liquor or other merchandise to the bankrupt on credit would be entitled to rely on this ownership of record. Appellee clearly permitted the bankrupt to exercise dominion over the license and to use the same in the operation of the bankrupt business.*"

We believe that at the time of filing of said Petition, no creditor would, or could extend credit to the lessee relying on any ownership of record of the license, for the lessee was ousted from the premises on September 30, 1954 (TR 17, Sec. IV), and said Petition was not filed until June 6, 1955. (TR 17, Sec. V.) We have a Stipulation as to what *facts* "shall be considered by the Court" in this matter (TR 15), and no such assumed fact of any creditor so "inquiring of the State Board" is in such Stipulation. It is appellant's mere speculation and conclusion.

Appellee did not permit lessee to "exercise dominion over the *license*". Lessee could not operate the bar leased with the premises, without a liquor license; nor could the lessor-appellee use his liquor license without the bar; the license being appurtenant to those premises.

Appellant cites (AOB 6), *Benedict v. Ratner* (1925), 268 U.S. 353, 69 L.Ed. 991, decided under the law of the state of New York. It was an action to set aside as a preference, an assignment of accounts receivable by the bankrupt, on the ground it was fraudulent as to creditors because, the bankrupt made the assignment as alleged security for a loan, but thereafter continued to collect and use for its own account, said collections; which the bankrupt was permitted to do under the terms of the loan and assignment. The assignment was declared fraudulent and void as to creditors, as to payments made to the bankrupt within four months preceding the bankruptcy. We are unable to see any application whatever of this case to the one

before this court. Certainly, after Appellee here transferred the license to Newcomb, *he* exercised no dominion whatever over it or over the business of lessee, except to collect his rent if possible, up to the time he foreclosed and retook possession of the hotel, and attempted to retrieve his liquor license.

Appellant cites *England v. Nyhan* (1944), (C.A. 9th), 141 F2d 311 (AOB 7), to what point, is not clear. Involved there was only the question, whether the referee erred in sustaining a plea to the summary jurisdiction to determine the interest of a claimant to rights in a taxi permit standing in the name of the bankrupt. The holding of the case is that "possession" of the property is sufficient to vest summary jurisdiction, and that since the bankrupt had possession of the permit standing in his name, the order of the referee sustaining the plea thereto, was in error. We are unable to see the application of this case to the instant one.

Appellant states that appellant represents the "creditors of the licensee who did business with and extended credit to the licensee-bankrupt on the basis of his record ownership of the license." (AOB 8.)

Again we point out that there is no evidence whatever in the record to sustain this statement. It is entirely appellant's self-serving assumption and conclusion. Appellant has stipulated to the facts which may be considered on this appeal, and he is bound by them, as well as appellee is bound.

Appellant states:

“It was held in the Matter of Norman A. Murphy . . . that ‘such’ creditors had no *duty* to look further than to the face of the license to determine whether or not the person with whom they were doing business was, in fact, the licensee.”

(AOB 8.)

And appellant cites this case as “Case No. 38370, U. S. District Court, Northern District of California.” We therefore had to make a trip to court to go over the file therein, and although same has been gone over very carefully, we do not find therein any opinion or decision whatever. We did find, however, such language in a brief of counsel for the bankruptcy trustee. But if there is such a decision, creditors have no “duty” to look at any license, and there is nothing in this record to establish that any creditor ever did look at the license involved in this case.

Appellant cites Sections 23009 and 23300, *B & P Code*, the first defining a “licensee” as any person holding a license issued by the board; and the second, providing that no person shall exercise the privilege which a licensee may exercise unless such person is authorized to do so by a license duly issued. (AOB 9.) And he then cites Section 24070, *B & P Code*, to the effect that a license is transferable from the licensee to another person upon the approval of the Board, now Department of Alcoholic Beverage Control; and the payment of a transfer fee; and states:

“It is clear that at no time prior to the filing of the Petition in Bankruptcy herein had appellee

obtained the approval of the Alcoholic Beverage Control Board to a transfer to him of the license in question, nor had he paid the transfer fee. Therefore, he could not be considered as the owner of the license.” (AOB 9.)

FIRST: It is provided in the Stipulation to Facts (TR 17, Sec. III):

“That on the said 25th day of July, 1946 . . . there *was no regulation* of the Board of Equalization of the State of California *preventing the legal execution and enforcement* of the provisions of paragraph Twenty-sixth of said lease hereinbefore set out; . . .”

SECOND: The same contention was made in *Campbell v. Bauer*, supra, 104 CA2d 740, 744, and the court held that the decree of specific performance of the retransfer agreement would be affirmed even though the application to the Board for the retransfer had not been made and the retransfer and issuance of the new license was subject to the approval of the Board, as it was nevertheless the duty of the holder of the license to make the application and that equity would regard it as having been done.

THIRD: The license *has already been transferred and sold* at public sale to a third party for \$6,000.00 (TR 20) and this controversy is over the *proceeds* of such sale. As shown, it was stipulated between the parties through their counsel that the license might be sold by the Trustee in Bankruptcy and that the proceeds thereof should be impounded by the Trustee and all claims of appellee be transferred to the pro-

ceeds of said sale without prejudice to any of the rights of appellee in said liquor license. (TR 14.) It is too late for the Trustee now to contend that the *appellee* has not “obtained the approval of the Board to a transfer to him of the license . . . and has not paid the transfer fee” and *hence*, that appellee “could not be considered as the owner of the license.” (AOB 9.)

“A trustee in bankruptcy is not in the position of a bona fide purchaser of the property and assets of the bankrupt, since he comes into them merely by operation of law. . . .

It is well settled that even the ‘strong arm’ clause in Sec. 70(c) of the Act confers only status as a creditor with lien obtained by legal or equitable proceedings, at the time of filing of the petition initiating proceedings under the Act. Such status frequently permits the trustee to upset transactions of the bankrupt which have not been, at time of filing of the petition, perfected as against the bankrupt’s creditors by proper recording or the like, and thus to assert such superior rights as a bona fide purchaser might also have been able to assert; but that is purely coincidental. The fact that a bona fide purchaser could hold the bankrupt’s prior transaction for naught is no test whatsoever of the trustee’s right or power to do so.”

Remington on Bankruptcy, 1957 Rev. Vol. 4, Sec. 1741.

There is no evidence whatever in the record that any creditor of the lessee-bankrupt *knew* that the license was in the name of Newcomb Interests, Inc., or that any creditor of said lessee ever extended any

credit to lessee allegedly based upon that ground; or that lessor-appellee ever knew or believed that any creditor was extending credit to lessee-bankrupt on that ground; but *on the contrary there is evidence* that appellee *gave public notice* to anyone who might be interested in the ownership of the license, of lessee's limited tenure thereof, and of lessor's beneficial ownership thereof, by recording the Lease in the County Recorder's Office of Santa Cruz County wherein the Casa Del Rey Hotel with bar, leased by appellee was situated, on August 5, 1946. (TR 15, Par. I.)

XII. B. The Bankrupt Could Not, (1) at Any Time Prior to the Filing of the Petition, by Any Means, Have Transferred the License (to Anyone But Appellee); and Did Not; Nor, at Said Time, (2) Could the License Have Been Levied Upon and Sold Under Judicial Process Against the Bankrupt, or Have Been Otherwise Seized or Impounded or Sequestered by Any Creditor or the Bankrupt; and Was Not; Nor, at the Date of Bankruptcy, (3) Could Any Creditor of the Bankrupt, Have Obtained a Lien Thereon by Legal or Equitable Proceedings.

This has reference to Section 70(a)(5) and Section 70(c) of the Bankruptcy Act, 11 U.S.C.A. 110(a)(5) and 110(c), quoted by Appellant (AOB 10), pointing out that the District Judge in his decision appealed from, *Huffman, as Trustee v. Farros*, 171 F. Supp. 704, held that: "property held under a trust cannot be reached by the trustee's creditors . . . The license, then, would be exempt from the claims of any creditors." (TR 40.)

It is the argument of appellant (AOB 11) that because it is held in *Golden v. State of California*

(1955), 133 CA2d 640, 645, 285 P2d 49, 53, that a liquor license was subject to a lien for U. S. Internal Revenue Taxes (there being no involuntary or constructive trust involved therein); and cites *In re Quaker Room*, supra, 90 F. Supp. 758, 760, holding that a liquor license is "property"; and that *Golden v. State* cites *U. S. v. Blackett* (1955), (CCA 9th) 220 F2d 21, 23, holding that even though a sale of a state liquor license was precipitated by a judgment creditor of licensee, that the proceeds of the sale were subject to the theretofore perfected Internal Revenue tax lien of the U. S. (there being no involuntary or constructive trust involved therein); that these authorities establish that the appellant Trustee herein was given a lien in this instant case by the foregoing Sec. 70(a)(5) and 70(c) of the Bankruptcy Act; and hence that the District Court erred in holding that: "creditors and thus Appellant Trustee could not obtain a lien on the liquor license." (AOB 12.) The conclusion does not follow and is without support. It will be noted that Appellant Trustee *does not question* the holding of the U. S. District Court that:

"... the corporation's (lessee's) retention of the license after the termination of the lease was wrongful. On property so retained the law of California imposes an involuntary or constructive trust . . . And it is settled that property held under a trust cannot be reached by the trustee's creditors."

And no such objection is the subject of Appellant's Specification of Errors. (AOB 2.) On the contrary, Specification (b) reads:

“The holding of the District Judge that the property *held under trust* cannot here be reached by the Trustee’s creditors since the beneficiary did nothing to induce the Trustee’s creditors to rely on the apparent worth of that title, is erroneous and contrary to law.”

Appellant does not expressly admit the trust, but it would seem that appellee is entitled to conclude from the foregoing that at least appellant does not question the trust finding and holding, of the District Court.

Appellant *does not claim* that, in the face of the failure or refusal of the lessee to retransfer the license as agreed, upon termination of its lease, and the consequent imposition of an involuntary trust upon the lessee, and the license; that the lessee-bankrupt could nevertheless have, prior to the filing of the petition, transferred the license to anyone but appellee; nor that in the face of lessee’s violation of his written agreement to retransfer, and the imposition thereupon of an involuntary trust, that any *creditor* of the bankrupt *lessee* could nevertheless have levied upon the license, and sold it under judicial process against the lessee; nor that at the date of bankruptcy any *creditor* of the *bankrupt*, in the face of the establishment of such involuntary trust, could have obtained a *lien* on the license *by legal or equitable proceedings*, which could be deemed vested in the Trustee as of such date. Hence it is contended by appellee that appellant has not established that said Sec. 70(a)(5) and/or Sec. 70(c) of the Bankruptcy Act, have any application to this instant case.

“If the trustee of an express trust becomes bankrupt, the property which he holds in trust does not vest in his trustee in bankruptcy. It is simply not ‘his’ property, but property which he has possession of for a special purpose and in a fiduciary capacity. . . .

The trustee in bankruptcy must recognize any rights against the property which comes to his possession which the bankrupt or debtor would have had to recognize.”

Remington on Bankruptcy, 1957 Rev. Vol. 3, p. 48, Sec. 1212.

“It is the well settled general rule that a trustee in bankruptcy takes title, under Sec. 70 (a) of the Bankruptcy Act, subject to all equities and defenses existing against the bankrupt at the time of filing of the petition instituting proceedings under the Act, and comes into no less, but no better, right or title than the bankrupt then had. It is true that under other provisions of the Act the trustee has the rights of an attaching, execution, or judgment creditor, that certain liens obtained by legal or equitable proceedings are void as against him, and that he can avoid fraudulent transfers and preferences as shown in subsequent chapters of this treatise; but these are exceptions to the rule, based on special provisions and *inapplicable* except as they fall within the scope of such provisions. . . .

The general rule stated above does not appear in so many words anywhere in the statute, but it is clearly inferable from the fact that under Sec. 70 (a) of the Act the trustee takes only ‘the title of the bankrupt’ and comes into that title

only by 'operation of law'. He is therefore not a bona fide purchaser, but merely a successor in title. (Authorities.)"

Remington on Bankruptcy, 1957 Rev. Vol. 3,
Sec. 1412.

A bankruptcy trustee takes bankrupt's property in same condition that bankrupt held it and subject to all valid legal or equitable liens not expressly rendered void by terms of section 1 et seq. of the Bankruptcy Act, in absence of fraud. *Cohen v. Wasserman* (C.C. Mass. 1956), 238 F2d 683.

It is further said in *Remington*, 1957 Rev. Vol. 5A, Sec. 2503:

"The right to reclaim property which was held in trust by the bankrupt for the reclaimant, and to which the bankrupt had no individual claim, is beyond question, as shown in the next succeeding section hereof. The reclaimant can recover the property itself, if still in possession of the bankrupt or of the bankruptcy court, or its avails or other property into which the avails have been transmuted if he can trace the avails and identify the property and it is in the bankruptcy court's possession."

". . . the right to trace and reclaim them . . . is founded deep in the law of trusts and equity jurisprudence."

Remington, 1957 Rev. Vol. 5A, Sec. 2504, p. 332.

"Notwithstanding his official status, the trustee in bankruptcy is in no stronger position than the bankrupt himself would have been to resist an

application to reclaim trust funds or property held in trust for the claimant.”

Remington, 1953 Rev. Vol. 5A, Sec. 2504, p. 335.

XII. C. A Bankruptcy Court Is a Court of Equity Dealing Primarily in the Equities of the Situation.

Remington on Bankruptcy, 1957 Rev. Vol. 3, page 346, Sec. 1417.

The following are pertinent authorities cited in Title 11 U.S.C.A. under the aforesaid Section 70(a)(5) and 70(c) of Bankruptcy Act (110 U.S.C.A. (a)(5) and 110(c)): The purpose of 70(c) was to vest in the bankruptcy trustee, such title as a bankrupt has under the law of the state where situated. *In re Richards & Holloway* (D.C. La. 1940), 35 F.Supp. 51. This section vests the trustee by operation of law, with such title as the bankrupt had, and in the absence of fraud, the trustee takes no better title, and with respect to the character of his title, the trustee occupies the same relation to creditors that the bankrupt sustained prior to the proceedings. *In re L. H. Duncan & Sons* (1942) (CA Pa.), 127 F2d 640. A trustee stands in the shoes of the bankrupt, except as against fraudulent conveyances and similar transactions, and can assert no greater right against one by whom premises were leased than could have been asserted by the bankrupt in absence of bankruptcy proceedings. *Schultz v. England* (C.A. 9th 1939), 106 F2d 764. A trustee in bankruptcy takes the property of the bankrupt subject not only to specific liens, but also to equities in favor of third persons, which are

not invalid as to creditors. *In re Sherwoods* (1913 CCA NY), 210 Fed. 754. If bankrupt holds property in trust for another, trustee in bankruptcy takes title to such property *charged with trust* and so long as property can be identified, it will be treated in bankruptcy as property to which creditors of the bankrupt *have no claim*, and will be paid over as a whole, before disbursements are made to lienholders or unsecured creditors. *City of Dallas v. Crippen*, (CA Tex. 1948), 171 F2d 526, cert. den. and reh. den., 336 U.S. 937 and 955. A bankruptcy trustee takes title to all property to which the bankrupt has title, though it be held in trust, but when it appears that the bankrupt is only a trustee and has no beneficial interest in or claim against the property, the Court should turn it over to its true owners where possible. *Todd v. Pettit* (C.A. Tex. 1939), 108 F2d 139.

The trustee in bankruptcy is not entitled to property in possession of the bankrupt which is held under an implied trust or to which a constructive trust attaches. *In re Franklin Savings & Loan Co.* (D.C. Tenn. 1940), 34 F. Supp. 661. Property held by a bankrupt by a mere naked legal title, and purely in trust for another, is no part of his estate in bankruptcy and does not pass to his trustee. *Lowell v. International Trust Co.* (Mass. 1907), 158 F. 781, 86 C.C.A. 137.

As to such property as was held by the bankrupt, at the time of his adjudication, in trust for another, it comes into the hands of his trustee in bankruptcy impressed with the rightful claims of the beneficiary

thereof, whose interests will be fully protected upon proper proof. *In re Davis* (D.C. Mass. 1901), 112 F. 129.

XII. D. Appellee's Answer to Appellant's Contentions That He May Deprive Appellee of His Right, Title and Beneficial Interest in and to Said License.

Breeze v. Brooks (1892), 97 Cal 72, was an action by the *creditors of John Brooks* to set aside his deed of certain land standing in his name, to his brother Patrick Brooks and to subject the land thus transferred to Patrick Brooks to their claims as creditors of John; on the ground that John's said deed to Patrick was fraudulent and made with intent to defraud them as John's creditors. The basic facts were substantially the same as those established in a former appeal, *Breeze v. Brooks*, 71 Cal 169, though somewhat stronger as against the creditors; and the following is with reference to the first decision: Patrick had paid all the consideration for the land in question and caused it to be placed in the name of John. The court held (71 C 181):

“That John had nothing except a naked legal title, and therefore *held same in trust* for Patrick. John thereafter deeded the land to Patrick, thereby conveying to the latter only that which belonged to him. (This was the deed sought to be set aside.) The court points out (71 C 181) that John was Patrick's tenant and never so far as Patrick knew, had asserted any title adverse to Patrick's; that it appeared that the creditors in giving credit to John had not relied on any statement of Patrick that John owned the land; nor is

it there intimated that they examined the *records of deeds* . . . to find out what they disclosed in reference to John's title, or relied on them in any way to induce the credit which they extended to John. They seem to have relied on the facts that John lived on the land, claimed it in his conversations with them, and that he was insolvent and Patrick knew it . . .”

(71 Cal 181):

“Therefore it does not appear that the deed from John to Patrick was made to hinder, delay, or defraud creditors; it was simply made to re-invest Patrick with the legal title to his own land. So that after this conveyance was made in good faith, John had no interest in the land, and if it was sold at sheriff's sale under execution, the *purchaser got no title*, as a purchaser at such sale can get no title save that of the judgment debtor . . .”

(71 Cal 182):

“So far as the findings disclose, Patrick did not act to induce creditors of John to believe the land was John's save that he allowed the title upon the record to stand in John's name, which record these creditors never examined . . .

It does not appear that Patrick had any knowledge that John was getting credit from anyone upon the faith of his apparent ownership of the land . . . in such a case we understand the authorities all to agree that one cannot be estopped to set up that which, but for such act, would be a good legal title to land.”

On the second appeal, 97 Cal 72, 75, the court referring to the former appeal, says:

“It was then held necessary that the plaintiffs (creditors), in order to entitle them to a recovery, should show that Patrick was in some way privy to John’s obtaining credit from them, or that in giving such credit they relied upon some affirmative statement or act of Patrick, other than his permitting the title to stand of record in John’s name; and the mere fact that Patrick allowed the title to the land to stand of record in the name of John was unavailing to plaintiffs, unless they could establish . . . that they relied thereon as an inducement to give credit to John.”

The court affirmed the judgment in favor of the defendants.

Murphy v. Clayton (1896), 113 Cal. 153, was an action to establish a resulting trust in land, which was conveyed into the name of D. J. Murphy alone, though one-half of the consideration of the purchase was paid by his mother, Ann, the plaintiff. Upon the death of D. J. Murphy, his administrator, defendant Clayton, took possession of said land, and claimed it, as an asset of the former’s estate. The court holds (113 Cal. 157):

“The consideration for the land having, at the time of the purchase, been paid, half of it by appellant’s intestate and half of it by the respondent, and the title taken by the former, a resulting trust arose in the land in favor of respondent for the undivided one-half thereof . . .

It is insisted by the appellant (Clayton) that he, as the representative of the creditors of the

deceased debtor, can assert the priority and superiority of their claims over the secret equity of the plaintiff . . . (113 C 158)

A resulting trust, being a purely equitable interest, is cut off and destroyed as against all *bona fide* purchasers or mortgagees from the trustee for a valuable consideration and without notice. (Auths.) (p. 159). . . . But it will be observed that in all these cases, as well as in the sections of the Code of Civil Procedure applicable to the estates of deceased persons, the possession and lien mentioned relate to the estate of *the decedent* (court's italics), and *not* to *that which he held in trust for others*. . . .

Neither the appellant nor any creditor of the decedent stands in the relation of purchaser or mortgagee of the property. Counsel for appellant does not mention any case which extends the doctrine of the cited cases or applies section 1107 of the Civil Code to mere creditors who have not advanced money on mortgage, or purchased at a sale . . .

Does the finding that the conveyance was made to D. J. Murphy, and that from the date thereof to the time of his death he was in the apparent sole possession and ownership, managing and dealing with the property as his own, with respondent's knowledge and consent, coupled with the finding that his credit was based, in part, upon the fact that the property stood in his name, and his indebtedness was contracted without notice to his creditors of respondent's equity, estop the respondent, and cut off that equity?

I do not think the facts found tend to establish such estoppel. They show no act, conduct, or ad-

mission upon the part of respondent by which the creditors were induced to give credit to the decedent. (p. 160) They do not show even that any of the creditors knew that the title to the property stood in his name, or that means were taken by any of them to ascertain the true state of the title."

In *Lux v. Haggin*, 69 Cal 266, the court said:

"To constitute the estoppel the party claiming the benefit of it must be destitute of knowledge of his own legal rights, and of the means of acquiring such knowledge. (Auths.)

To constitute such an estoppel it must also be shown that the person sought to be estopped has made an admission or done an act, *with the intention* (court's italics) of influencing the conduct of another, or that he had reason to believe would influence his conduct, inconsistent with the evidence he proposes to give, or the title he proposes to set up; that the other party has acted upon or been influenced by such act or declaration; that the party so influenced will be prejudiced by allowing the truth of the admission to be disproved. (Auths.) . . . Equity does not favor estoppels."

The court then refers with approval to the cases of *Breeze v. Brooks*, 71 Cal 167 and 97 Cal 72, and quotes to some extent from the first case, and concludes (p. 162):

"There is nothing illegal or against public policy in the mere fact that a party equitably entitled to real property permits the legal title to remain in another; resulting trusts are fully recognized

by our law; and every one is presumed to know the law. (Auths.)”

The court affirms the judgment.

Bank of Cottonwood v. Henriques (1928), 91 CA 88, involved fact situations substantially similar from the legal viewpoint, to those of the foregoing cases of *Breeze v. Brooks*, and *Murphy v. Clayton*, and the court cites those cases as controlling, and holds to the same effect in all respects.

In re Rogal (1953), 112 F. Supp. 712 (USDC-S.D. Cal. Central Division), was on a petition for review of the Bankruptcy Referee’s order, denying a Petition of the father of the bankrupts, to impress a trust on California business and residential realty, to which bankrupts had naked legal title. The court holds (716):

(2-4)

“As we are dealing with real property situated in California, rights of the parties to it must be determined, not according to general principles, but by the rules laid down by California courts in determining such rights. (The court cites and quotes sections 853 and 2224 of the California Civil Code, and referring thereto says, p. 717):

(5)

California courts in giving effect to these sections, have, for a period of over three-quarters of a century, held that a person may place the legal title in another in trust for himself, and that the legal owners will be compelled by the courts to restore title to the property, if they

repudiate the trust. These principles have been applied with great uniformity to dealings between persons standing in fiduciary relationships, such as (here the court refers to quite a few California cases dealing with such trusts).

The only deviation from the principle established by these cases arises in the case of a *bona fide* purchaser for value without notice. As to him the California Civil Code specifically provides as to both resulting and express trusts (Quoting sections 856 and 869):

(6)

California courts have held that an attachment or judgment creditor is not a *bona fide* purchaser for value. (Auths.) Both Collier and Remington state emphatically that the trustee does not take title as a *bona fide* purchaser for value without notice of equities. (Citing thereto.)”

The Court of Appeals for the Fifth Circuit has summed up the rule and the reason for it in a brief opinion which reads:

“The court disallowed a claim of the appellant that it was entitled to an equitable lien on land of the bankrupt which was intended to be included in a deed of trust . . . but by mutual mistake of the parties . . . was omitted. Under the recording laws of Texas the equitable title of the appellant to the omitted land was not required to be recorded in order to protect it against creditors of the bankrupt in whose favor an attachment or an execution on a judgment against the bankrupt was issued. (Auth.) Under amended section 47a of the Bankruptcy Act (11 USCA Sec. 75),

the trustee in bankruptcy has the status of such a creditor, *not the status of a bona fide purchaser for value and without notice.* (Court's italics) (Auths.) The rights of the trustee in bankruptcy being subordinate to those of the appellant, based on the asserted equitable claim, which was supported by the evidence, the disallowance of that claim was erroneous." (Cit.)

(The court then quotes with approval from the foregoing case of *Breeze v. Brooks* (1892), 97 Cal. 72, 76-77, as partly quoted in this brief in this instant case. The court follows the cases referred to in the decision including *Breeze v. Brooks*.)

The court also cites *Williams v. Levy* (1931), (CA 9th), 54 F2d 18, where a very similar fact situation to that in *In re Rogal*, and in the instant case was involved, and wherein the court says:

"The case as made by the facts is one where the bankrupt, prior to bankruptcy, took the naked legal title to property, the whole ownership of which was in appellee, with the duty upon demand of appellee to transfer the same to him. It would be strange indeed if in such a situation, where bankruptcy has intervened, the trustee of the title holder's estate could, by securing an order of a referee to that effect, wipe out all of the property rights of the owner in the land. There is not a finding, as made by the referee, which can justify the order which was reviewed by the district judge. No situation was presented or claimed as that where the purchaser of property has had title taken in the name of another person, *and has knowingly allowed such person to obtain*

credit upon the representation that he was the true owner thereof. (Court's italics.) Neither are the rights of any innocent transferees involved. The case is so plain as that a mere statement of the undisputed facts answers every argument of the trustee."

It is contended by appellee herein that this *Williams v. Levy* case, is quite applicable to the instant case before this court.

CONCLUSION.

By reason of the premises, it is contended that the Order of the District Court of April 2, 1959, reversing and setting aside the Order of the Referee granting the Petition of the Trustee-Appellant to Sell the Liquor License Free and Clear of any right, title, interest or claim of Appellee, in or to same, should be affirmed.

Dated, San Francisco, California,
September 30, 1959.

Respectfully submitted,

A. DON DUNCAN,

Attorney for Appellee.

No. 16,491
United States Court of Appeals
For the Ninth Circuit

S. B. HUFFMAN, Trustee of the Estate
of Newcomb Interests, Inc., a cor-
poration, doing business as Casa Del
Rey Hotel, Bankrupt,

Appellant,

VS.

HARRY A. FARROS,

Appellee.

APPELLANT'S CLOSING BRIEF.

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HARRY A. FARROS,

Appellee.

APPELLANT'S CLOSING BRIEF.

SUMMARY OF APPELLANT'S POSITION.

Appellant's position will be more fully stated hereinafter in connection with his reply to specific points advanced by Appellee.

The major premise of Appellant is that the liquor license in question is property which passed to the Appellant Trustee in Bankruptcy and is property subject to a creditor's claim of lien.

After reading Appellee's brief, we have no hesitation to state that it represents a substantial exposition of various principles of law. However, as we will hereinafter point out, we do not believe that the interpretation of the law therein set forth is applicable in the case at bar.

COMMENT ON APPELLEE'S POINTS.

In support of his argument that the lease agreement under which the license was transferred from Appellee to the bankrupt is not affected by the passage of Section 7.3 of the Alcoholic Beverage Control Act, Appellee cites various state court cases (at pages 5 and 6 of his Brief), to-wit, *Cavalli v. Macaire*, 159 CA 2d 714, 324 P 2d 336; *Tognoli v. Taroli*, 127 CA 2d 426, 273 P 2d 914; *Pehau v. Stewart*, 112 CA 2d 90, 245 P 2d 692; *Etchart v. Pyles*, 106 CA 2d 549, 553, 554, 235 P 2d 427; *Campbell v. Bauer*, 104 CA 2d 740, 232 P 2d 590; *Saso v. Furtado*, 104 CA 2d 759, 769, 232 P 2d 583, 589. The basic holding of these cases is that Section 7.3 of the Alcoholic Beverage Control Act has no retroactive effect *as between the parties to the transaction* and go off on the point that "defendants have shown no equities, and, in our opinion, it would be unjust enrichment to hold that they were entitled to retain the license." *Cavalli v. Macaire, supra*, 324 P 2d 339. We find nothing in these cases involving liquor licenses to support the involuntary trust theory advanced by the District Judge, and by Appellee. We will hereinafter, as we did in our Opening Brief, show the equities which exist in favor of Appellant herein.

Appellee, in his brief, pages 30-31, apparently takes the position that Appellant does not question the holding of the District Judge that the retention of the license after the termination of the lease was wrongful and that an involuntary or restrictive trust was created, cites Appellant's Concise Statement of Points Urged on Appeal 1(b) (T.R. p. 62), and quotes said

Specification on page 31. We are at a loss to understand how we could more clearly express our position than to therein state that such holding “*is erroneous and contrary to law*”.

It is Appellee’s contention that no creditor of the bankrupt lessee could claim that he was without notice of Appellant’s claim of ownership to the license by reason of the recordation of the lease agreement with the County Recorder of Santa Cruz County. In support of this position, Appellee cites (in part, at page 21), California Civil Code Section 1213, and we recite the same provision italicizing portions thereof so that the purpose of the recordation of the lease will be clear to the Court.

“Every conveyance of real property acknowledged or proved and certified and recorded as prescribed by law from the time it is filed with the recorder for record is constructive notice of the contents thereof to subsequent purchasers and mortgagees; . . .”

The lease here was recorded because of its effect on *real property* and has no relation to the question of the transfer of the liquor license. We repeat (as we stated on page 9 of our Opening Brief) that the provisions of the Alcoholic Beverage Control Act are the sole guide for persons doing business with a licensee and no constructive notice is imparted as to this transaction by the recordation of the lease. On page 19 of Appellee’s Brief, is a paragraph taken from 25 Cal. Jur. 222, Section 90, as to the effect of knowledge by a person acquiring property that the transferor had

merely legal title, equitable ownership being in a third person, but here the creditors of the bankrupt had no knowledge, actual or constructive, of the terms of the lease since the bankrupt was the named licensee.

On page 24 of his Brief, Appellee states that no creditor did or could extend credit to the bankrupt because it had been ousted from the premises on September 30, 1954, and goes on to state that the facts to be considered by the Court were stipulated to and no assumed facts such as a creditor "inquiring of the State Board" can be considered, and further that Appellee did not permit the bankrupt to exercise dominion over the license. It appears to us that this position begs the very question before the Court.

We would here point out simply that on the date of the filing of the petition in bankruptcy herein (June 1, 1955) the license still stood in the name of the bankrupt with the knowledge and consent of Appellee, although the bankrupt had been in default for a period of eight months prior thereto, even after termination of the lease. There we have an equity in favor of Appellant Trustee not present in the State Court cases above referred to.

England v. Nyhan, (9th Cir.) 141 Fed. 2d 311, was cited in Appellant's Opening Brief at page 7 for the point therein set forth that at the time of the filing of the petition in bankruptcy the permit to operate the taxicab was in the name of the bankrupt and by the provisions of the law he was the only person able to operate under and to transfer a permit. We believe the analogy between that taxicab license and this

liquor license should answer the query of Appellee on page 25 of his Brief.

On pages 27 and 28 of his Brief, Appellee points out that the license had been sold and that this controversy is over the proceeds of the sale and that therefore it is too late for the Appellant Trustee to contend that the Appellee "had not obtained the approval of the Board to a transfer to him of the license . . . and has not paid the transfer fee." We submit that the license was sold by stipulation (T.R. pp. 13-14) between Appellee and Appellant without changing the actual facts. Certainly Appellee cannot state that the license was sold prior to bankruptcy, which is the basis for Appellant's position as set forth in his Opening Brief on page 9, a portion of which is set forth in the above quotation.

On pages 43 and 44 of his Brief, Appellee cites *Williams v. Levy*, 1931 (9th Cir.) 54 Fed. 2d 18, and on page 44 sets forth his contention that this case is quite applicable to the instant case with which point we are in agreement. In the portion quoted on pages 43 and 44, and particularly the italicized portions thereof and by applying this principle of law, to-wit, that where there are no innocent transferees *and the beneficial owner has not knowingly permitted the legal owner to obtain credit by representing himself to be the true owner*, such property is not subject to sale as property of the bankrupt estate, we find here that the license was put in the name of the bankrupt so that he could operate as the licensee and obtain credit since without the license he could not operate and pay

the rent to Appellee or obtain credit under the provisions of the Alcoholic Beverage Control Act, and the Appellant (alleged beneficial owner) here has clearly permitted the bankrupt (legal owner) to obtain credit by representing itself to be the actual owner of the license.

We would here reiterate our argument set forth on pages 5-10 of Appellant's Opening Brief that the liquor license is property which passed to the Appellant Trustee in Bankruptcy. (See Section 70a(5), Bankruptcy Act, 11 U.S.C.A. 110a(5), cited on page 10 of Appellant's Opening Brief.)

Our point that the liquor license is property subject to a creditor's claim contrary to the opinion of the District Judge, is covered by our argument on this point, pages 10-12 of Appellant's Opening Brief, and by "Appendix A" of said Opening Brief.

In support of Appellant's position that the liquor license could have been levied upon, we would call the Court's attention to the amendment to Section 688 of the Code of Civil Procedure of California passed by the Legislature in its 1959 session whereby a license issued by the State of California to engage in any business or activity was specifically made exempt from levy or sale on execution. See the discussion of this amendment in 34 *Journal of the State Bar of California* 5, at page 642, wherein it is pointed out that the seizure, removal and execution sale of State issued business and professional licenses often frustrated administration of the liquor laws, this being the main reason for the amendment above referred to. Appar-

ently the California Legislature as well as the Appellant here considered a liquor license as subject to the claims of creditors.

CONCLUSION.

In view of the facts and law hereinabove set forth, it is Appellant's contention that the "non-retroactive effect" of the provisions of Section 7.3 of the Alcoholic Beverage Control Act (as between the parties to an agreement to transfer a license), do not apply to Appellant; that the creditors of the bankrupt could have obtained a lien on the liquor license and that the liquor license is, therefore, properly an asset of the bankruptcy estate, and that Appellee cannot reclaim same, and that the Memorandum and Order of the District Judge here complained of, should be, by this Court, reversed and remanded with instructions to the District Court to make and enter an Order in said bankruptcy proceedings affirming the Referee's Order of November 2, 1956.

Dated, Burlingame, California,
November 23, 1959.

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No. 16496 ✓

United States
Court of Appeals
for the Ninth Circuit

WILBUR SECURITY COMPANY,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of Record

Petition to Review a Decision of The Tax Court
of the United States

FILED

OCT 12 1959

PAUL P. O'BRIEN, CLERK

No. 16496

United States
Court of Appeals
for the Ninth Circuit

WILBUR SECURITY COMPANY,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of Record

Petition to Review a Decision of The Tax Court
of the United States

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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Attorney for Respondent.



Tax Court of the United States

Docket No. 68408

WILBUR SECURITY COMPANY,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION

1. The Petitioner is a duly authorized Washington corporation with its principal office being located in the City of Wilbur, State of Washington. The returns for the periods here involved were filed with the District Director of Internal Revenue at Tacoma, Washington.

2. The statutory notice of deficiency (a copy of which is attached hereto and marked Exhibit "A"), was mailed to the Petitioner on June 7, 1957.

3. The deficiency in tax as asserted by the Commissioner is in income taxes for the calendar years 1953, 1954, and 1955, in the aggregate amount of \$48,465.61, of which the entire amount is in dispute.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in disallowing the following amounts as interest deductions to the Petitioner for each of the following taxable years:

Year	Interest Deductions Denied
1953.....	\$32,311.10
1954.....	\$33,151.10
1955.....	\$33,151.10

(b) The Commissioner of Internal Revenue erred by increasing Petitioner's income for the taxable year 1953 in the amount of \$840.

5. The facts upon which the Petitioner (hereinafter referred to as the Petitioner or as the corporation) relies on as a basis of this proceeding are as follows:

(a) Petitioner was organized in March of 1915, with an authorized capital of \$25,000, which was divided into 250 shares of the par value of \$100 a share.

(b) Subsequent to its organization, the Petitioner from time to time borrowed sums of money from its stockholders and other individuals. During the taxable years, 1953, 1954, and 1955, the amount of such loans, from stockholders, and other individuals who owned no stock in Petitioner, was approximately \$552,518.40. The loans made by the stockholders to the Petitioner in the years involved herein were not made in proportion to their stock ownership. A portion of the above indebtedness was owed to individuals who owned no stock in Petitioner.

(c) During the taxable years 1953, 1954, and 1955, the working capital available to Petitioner far exceeded the amount of the loans outstanding; the

value of Petitioner's assets, plus surplus, far exceeded the amount of loans outstanding.

(d) During the taxable years 1953, 1954, and 1955, the Petitioner paid the following amounts of interest on the outstanding loans as was provided for in the notes issued to the creditors of the Petitioner:

Year	Interest Paid
1953.....	\$32,311.10
1954.....	\$33,151.10
1955.....	\$33,151.10

(e) Some of the interest paid by the Petitioner on the corporate indebtedness, which was evidenced by notes issued by Petitioner to the creditors, was paid during the taxable years 1953, 1954, and 1955, to individuals who owned stock in Petitioner and some of the interest so paid was to individuals who possessed no stock ownership in Petitioner. The payments of interest made to persons possessing a stock ownership in the Petitioner were not made pro-rata in accordance with the stock ownership.

(f) It was never the intention of any creditor of Petitioner that the loans made to Petitioner should be subordinate to other creditors and accordingly the loans were never subordinated to other indebtedness. The loans to Petitioner were not intended to be at the risk of the business and were at all times intended as amounts that would be paid by Petitioner on demand or at the time provided for in the notes which evidenced the indebtedness.

(g) During each of the taxable years, 1953, 1954, and 1955, Petitioner paid a dividend to its stockholders.

(h) Petitioner deducted the interest payments made in the taxable years 1953, 1954, and 1955, from its income in arriving at its taxable income for said years and said deductions should not have been disturbed by the Commissioner of Internal Revenue, since the interest payments were made on bona fide loans and properly deductible.

(i) During the taxable year 1953, one of Petitioner's noteholders received a repayment of \$14,000. This amount was later re-loaned to Petitioner. Petitioner received no payment of interest in the amount of \$840.

Wherefore it is prayed that this court hear the proceeding and find that Petitioner herein properly reported its income for each of the taxable years, 1953, 1954, and 1955, and that the Commissioner of Internal Revenue has erroneously asserted Petitioner had a deficiency in its income tax for the taxable years, 1953, 1954, and 1955.

/s/ PAUL CASTOLDI.

/s/ FRANCIS J. BUTLER.

Duly Verified.

Form 1231 (App.)

123 U. S. Court House

Seattle 4, Washington

June 7, 1957

Ap:S:AA:90D

JAF:JHR

Wilbur Security Company

Wilbur

Washington

Gentlemen:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1953, December 31, 1954 and December 31, 1955 disclosed deficiencies in tax aggregating \$48,465.61 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward

it to the Assistant Regional Commissioner, Appellate, 123 U. S. Court House, Seattle 4, Washington. The signing and filing of this form will expedite the closing of your case by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is the earlier.

Very truly yours,

RUSSELL C. HARRINGTON,
Commissioner,

By /s/ JAMES E. WESTIN,
Associate Chief, Appellate Division.

Enclosures:

Statement

Agreement Form

IRS Pub. No. 160

JAF:JHR:hme

Ap:S:AA:90D

JAF:JHR

STATEMENT

Wilbur Security Company
Wilbur, Washington

Tax liability for the taxable years ended December 31, 1953,
December 31, 1954 and December 31, 1955.

Income Tax

Year	Liability	Assessed	Deficiency
1953	\$ 41,259.35	\$27,302.09	\$13,957.26
1954	46,142.74	28,888.57	17,254.17
1955	41,206.81	23,952.63	17,254.18
Total	<u>\$128,608.90</u>	<u>\$80,143.29</u>	<u>\$48,465.61</u>

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated October 8, 1956; to your protest dated March 12, 1957 and to the statements made at the conference held on April 24, 1957.

A copy of this letter and statement has been mailed to your representative, Mr. Paul Castoldi, 811 Paulsen Building, Spokane, Washington, in accordance with the authority contained in the power of attorney executed by you.

Taxable Year Ended December 31, 1953

Adjustments to Net Income

	Income Tax	Excess Profits Tax
Net income disclosed by return, Form No. 1120	\$57,889.47	\$79,842.80
Unallowable deductions and additional income:		
(a) Interest income	840.00	840.00
(b) Interest expense	32,311.10	8,077.77
(c) Depreciation	30.00	30.00
	<hr/>	<hr/>
Net income as adjusted	\$91,070.57	\$88,790.57
	<hr/> <hr/>	<hr/> <hr/>

Explanation of Adjustments

(a) On your 1953 return the amount of \$840.00 representing interest at 6% on a \$14,000.00 loan to the Estate of Sarah Farnsworth was not included in taxable income, but was applied as an offset against purported interest expense. Taxable income reported has been increased to include this unreported interest income.

(b) The amount of \$32,311.10 claimed on your return as a deduction for interest expense is disallowed on the ground that it did not constitute interest on indebtedness. In view of the foregoing, excess profits net income is increased in the amount of \$8,077.77 to reflect the elimination of the adjustment for interest on borrowed capital.

(c) On January 1, 1953 you acquired the Wilbur Garage Building, together with land, at a total cost of \$24,477.91. Based upon known values of adjacent and similar property it is held that \$1,000.00 of such cost should be allocated to the land and that the remainder or \$23,477.91 correctly reflects the basis of the

building on which depreciation is allowable at the rate of 3% as claimed on your return. Accordingly, allowable depreciation is reduced in the amount of \$30.00 in each of the years 1953, 1954 and 1955 to reflect the elimination of depreciation claimed on the land.

Computation of Tax

Net income adjusted	\$ 91,070.57
Less: Dividends received credit (85% of \$25.00)	21.25
	<hr/>
Surtax net income	\$ 91,049.32
Less: Excess of net long term capital gain over net short term capital loss	2,255.00
	<hr/>
Surtax net income for purpose of alternative tax	\$ 88,794.32
	<hr/> <hr/>
Combined normal tax and surtax on \$88,794.32 at 52% minus \$5,500.00	\$ 40,673.05
Plus: 26% of net long term capital gain	586.30
	<hr/>
Income tax liability	\$ 41,259.35
Excess profits tax	None
	<hr/>
Total income and excess profits tax	\$ 41,259.35
Assessed: Original Account No. OF-200032	27,302.09
	<hr/>
Deficiency	\$ 13,957.26
	<hr/> <hr/>

Excess Profits Credit—Based on Invested Capital

1. Equity (invested) capital at beginning of year asset method	\$752,756.65
2. Average addition for taxable year	<hr/>
3. 75% of average borrowed capital for year	<hr/>
4. Recent loss adjustment (Asset Method only)	<hr/> <hr/>
5. Total (Lines 1-4)	752,756.65
	<hr/> <hr/>
6. Average reduction for taxable year	<hr/> <hr/>
7. Balance (Line 5 minus Line 6)	752,756.65
	<hr/> <hr/>
8. Net new capital addition (where applicable— Asset Method Only)	<hr/> <hr/>
9. Invested capital (Line 7 minus Line 8)	\$752,756.65
	<hr/> <hr/>

10. Portion of Invested Capital and Applicable Credit	
Portion (\$752,756.65) not over 5,000,000 at 12%	90,330.80
Portion (\$.....) over 5,000,000 but not over 10,000,000 at 10%	
Portion (\$.....) over 10,000,000 at 8%	
11. Invested Capital Credit (Total of Line 10)	90,330.80
12. Total inadmissible assets	\$ 500.00
13. Total Assets	\$748,908.34
14. Percentage which Line 12 is of Line 13	.0667638%
15. Reduction for inadmissible assets (Line 11 multiplied by line 14)	60.31
16. Line 11 minus Line 15	\$ 90,270.49
17. New capital credit (12% of line amount on line 8)	
18. Excess Profits Credit—Based on Invested Capital (Line 16 plus Line 17)	\$ 90,270.49
Excess Profits Tax	
Excess profits net income as corrected	\$ 88,790.57
Excess profits credit	90,270.49
Adjusted excess profits net income	None
Excess profits tax	None

Taxable Year Ended December 31, 1954

Adjustments to Net Income

Net income disclosed by return, Form No. 1120	\$ 68,881.86
Unallowable deductions and additional income:	
(a) Interest expense	33,151.10
(b) Depreciation	30.00
Net income adjusted	\$102,062.96

Explanation of Adjustments

(a) The amount of \$33,151.10 claimed on your return as a deduction for interest expense is disallowed on the ground that it did not constitute interest on indebtedness.

(b) For explanation of adjustment see Item (c) above.

Computation of Tax

Net income adjusted	\$102,062.96
Less: Net long term capital gain	5,500.00
Balance subject to tax	<u>\$ 96,562.96</u>
Partial tax (52% of 96,562.96 minus \$5,500.00)	44,712.74
Plus: 26% of net long term capital gain	<u>1,430.00</u>
Income tax liability	\$ 46,142.74
Assessed: Original Account No. CF-200121	<u>28,888.57</u>
Deficiency of income tax	<u><u>\$ 17,254.17</u></u>

Taxable Year Ended December 31, 1955

Adjustments to Net Income

Net income disclosed by return, Form No. 1120	\$ 56,639.68
Unallowable deductions and additional income:	
(a) Interest expense	33,151.10
(b) Depreciation	<u>30.00</u>
Net income adjusted	<u>\$ 89,820.78</u>

Explanation of Adjustments

(a) The amount of \$33,151.10 claimed on your return as a deduction for interest expense is disallowed on the ground that it did not constitute interest on indebtedness.

(b) For explanation of adjustment see Item (c) above.

Computation of Tax

Net income adjusted	\$ 89,820.78
Income tax liability (52% of \$89,820.78 minus \$5,500.00)	41,206.81
Assessed: Original Account No. CI-200166	<u>23,952.63</u>
Deficiency of income tax	<u><u>\$ 17,254.18</u></u>

Served and Entered June 27, 1957.

[Endorsed]: T.C.U.S. Filed June 24, 1957.

[Title of Tax Court and Cause.]

ANSWER

The Respondent, in answer to the petition filed in the above-entitled case, admits and denies as follows:

1. Admits the allegations of paragraph 1 of the petition.

2. Admits the allegations of paragraph 2 of the petition.

3. Admits the allegations of paragraph 3 of the petition.

4. (a) and (b) Denies that the respondent erred in his determination of deficiencies in income tax as set forth in the notice of deficiency from which the petitioner's appeal is taken. Specifically denies that he erred in the manner and form as alleged in paragraph 4 (a) and (b) of the petition.

5. (a) Admits that petitioner was organized in March, 1915. Denies the remaining allegations of paragraph 5 (a) of the petition.

(b) and (c). Denies the allegations of paragraph 5 (b) and (c) of the petition.

(d). Admits that petitioner paid the amounts of \$32,311.10, \$33,151.10 and \$33,151.10 during the respective taxable years of 1953, 1954 and 1955. Denies the remaining allegations of paragraph 5 (d) of the petition.

(e) and (f). Denies the allegations of paragraph 5 (e) and (f) of the petition.

(g). Admits the allegations of paragraph 5 (g) of the petition.

(h). Admits that petitioner claimed deductions

for interest payments in the taxable years 1953, 1954 and 1955, in reporting its taxable income for those years. Denies the remaining allegations of paragraph 5(h) of the petition.

(i). Denies the allegations of paragraph 5 (i) of the petition.

6. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the deficiencies determined by the respondent be in all respects approved.

/s/ NELSON P. ROSE, (W.H.P.)

Chief Counsel, Internal Revenue
Service.

Of Counsel: Melvin L. Sears, Regional Counsel,
Wilford H. Payne, Assistant Regional Counsel,
John H. Welch, Attorney, Internal Revenue
Service, 211 U. S. Court House, Seattle 4,
Washington.

Served and Entered August 6, 1957.

[Endorsed]: T.C.U.S. Filed July 31, 1957.

[Title of Tax Court and Cause.]

STIPULATION OF FACTS

It is hereby stipulated that, for the purpose of this case, the following statements may be accepted as facts and all exhibits referred to herein and at-

tached hereto are incorporated in this stipulation and made a part thereof, subject to the right of either party to object to the admission of such facts and exhibits in evidence on the grounds of materiality or relevancy; provided, however, that either party may introduce other and further evidence not inconsistent with the facts herein stipulated.

1. The Wilbur Security Company (hereinafter referred to as the Petitioner or the Corporation) is a duly authorized Washington corporation with its principal office being located in the City of Wilbur, State of Washington. The following were the subscribers to the original stock of the corporation:

Name	Stock	Amount Subscribed For
E. L. Farnsworth	120 Shares	\$12,000.00
J. McPherson	105 Shares	10,500.00
Charles Hudkins	10 Shares	1,000.00
G. Thompson	10 Shares	1,000.00
E. H. Oswalt	5 Shares	500.00
<hr/>		
Total	250 Shares	\$25,000.00

2. There is attached hereto marked Exhibit 1-A and made a part of this stipulation by reference, the United States Corporate income tax return and attached schedules filed by the corporation for the taxable year 1953 with the District Director of Internal Revenue at Tacoma, Washington.

3. There is attached hereto marked Exhibit 2-B and made a part of this stipulation of facts by reference, a consent signed by the Commissioner of Internal Revenue and the corporation extending the period of limitation upon assessment for the taxable year 1953 to June 30, 1958.

4. There is attached hereto marked Exhibit 3-C and made a part hereof by this reference, the United States Corporate income tax return filed by Wilbur Security Company for the taxable year 1954 with the District Director of Internal Revenue at Tacoma, Washington.

5. There is attached hereto marked Exhibit 4-D and made a part of this stipulation by this reference, the United States Corporation income tax return filed by the Wilbur Security Company for the taxable year 1955 with the District Director of Internal Revenue in Tacoma, Washington.

6. The Corporation was organized on the 18th day of March, 1915. There is attached hereto marked Exhibit 5-E and made a part of this stipulation by this reference, a copy of the minutes of the first meeting of the Corporation together with the original articles of incorporation.

7. On the 5th day of April, 1915, the stockholders of the Petitioner held a meeting. There is attached hereto marked Exhibit 6-F and made a part hereof by this reference, a copy of the minutes of said meeting. The provision contained in Amendment 1, Article XII of the By-Laws has never been amended in the minutes of the Corporation.

8. There is attached hereto, marked as Exhibit 7-G and made a part of this stipulation by reference, a copy of the minutes of a special meeting of the trustees of Wilbur Security Company held on the 28th day of December, 1916. Pursuant to the action taken at the said meeting, the sum of

\$25,000 was set up in the books of the Corporation as paid-in capital.

9. There is attached hereto and marked Exhibit 8-H, a computation which shows the amounts in the stockholder accounts during each of the years 1915 until 1938. This amount of \$200,000 was from 1915 until 1938 carried in the corporate books under the heading of "Special Stockholders Account."

10. In addition to the \$200,000 referred to in Exhibit 8-H above, the Corporation obtained money from other sources. There is attached hereto marked Exhibit 9-I and made a part of this stipulation by this reference, a computation which shows the amounts so obtained in each of the years 1915 to 1938 and the source from which it was obtained. These amounts were carried on the books of the Corporation during these years under the heading of "Special Account."

11. Grace Phillips, referred to in Exhibit 9-I was the daughter of E. L. Farnsworth. Kate and Julie McPherson are the sisters of J. McPherson. Neither Grace Phillips, Kate or Julie McPherson owned any stock in the Corporation during any of the years 1915 to 1938. D. K. McPherson is the father of J. McPherson.

12. At a special meeting of the Wilbur Security Company held in the office of the Wilbur Security Company, June 5, 1939, it was unanimously adopted and carried that the "Stockholders Account" on the books of the Wilbur Security Company which totaled \$200,000 should be paid off and distributed to the owners thereof. There is attached hereto marked

Exhibit 10-J and made a part of this stipulation by reference, a copy of the original minutes of said meeting. There is also attached hereto and marked Exhibit 11-K and made a part of this stipulation by this reference, a copy of the direction to the Wilbur Security Company to pay over the \$200,000 referred to in the minutes of the meeting held June 5, 1939, signed by the then owners of the stockholders' account.

13. The books of the corporation under the above said date show the above change referred to in paragraph 12, above, as follows:

As of the 5th day of June, 1939, the amounts outstanding in the stockholders' accounts were paid by cash, per books, to the individuals having balances in the said accounts. On the same date the books show that the same amounts were re-deposited in the "Special Account" to the credit of the same individuals.

No cash actually changed hands and no checks were drawn but book entries were made indicating a payment of the stockholders' account.

As of this date the special account balances on the books of the Corporation equalled the total balances shown on Exhibits 8-H and 9-I.

There is attached hereto and marked Exhibit 12-L a schedule showing the outstanding balances in the Special Account from 1939 to 1942.

14. Attached hereto marked Exhibit 13-M and made a part of this stipulation by reference, is a copy of the minutes of directors or trustees of Wil-

bur Security Company held on the 19th day of January, 1943, and on the 20th day of January, 1943.

There is attached hereto marked Exhibit 14-N and made a part of this stipulation by reference, the entries made in the books of the Corporation pursuant to the action of the board of trustees referred to in Exhibit 13-M above. The entries contained in Exhibit 14-N represent all of the said entries on the bills payable account from the above date until December 31, 1955.

15. There is attached hereto marked Exhibit 15-O and made a part of this stipulation by reference, the minutes of the meeting of the board of trustees of the Wilbur Security Company, held January 13, 1953.

16. There is attached hereto marked Exhibit 15-O(a) and made a part of this stipulation by reference, the minutes of the meeting of the Board of Directors of the Wilbur Security Company dated December 1, 1953.

17. There is attached hereto marked Exhibit 16-P and made a part of this stipulation by reference, the minutes of the meeting of the trustees of the Wilbur Security Company held on the 12th day of January, 1954.

18. There is attached hereto marked Exhibit 17-Q and made a part of this stipulation by reference, the minutes of a meeting of the trustees of the Wilbur Security Company held on the 11th day of January, 1955.

19. There is attached hereto and marked Exhibit

18-R and made a part of this stipulation by this reference, a schedule which shows the stock ownership in the corporation at the end of each year from 1915 until 1955, in terms of stock certificates issued.

The ninety shares of stock shown as acquired by Grace Phillips in the year 1955 were acquired by a stock certificate issued on or about August 17, 1955.

20. There is attached hereto marked Exhibit 19-S and made a part of this stipulation by reference a schedule showing the amounts outstanding in the Bills Payable account in each of the years 1943 to 1955, inclusive.

The \$63,829.80 amount added to the total shown in 1955 of Grace Phillips was transferred per the books of the Corporation as of December 31, 1955.

21. During the taxable years 1953, 1954, and 1955, the stock of record of the Wilbur Security Company was held in the following amounts and in the following percentages:

Stockholder	No. 1953		No. 1954		No. 1955	
	Shares	%	Shares	%	Shares	%
Grace Phillips					90	36%
Sarah Farnsworth	90	36%	90	36%		
Elizabeth McPherson	5	2%	5	2%	5	2%
J. McPherson	102½	41%	102½	41%	102½	41%
J. K. McPherson	25	10%	25	10%	25	10%
E. H. Oswalt	7½	3%	7½	3%	7½	3%
G. Thompson	20	8%	20	8%	20	8%
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
	250	100%	250	100%	250	100%

22. During the taxable years 1953, 1954, and 1955, the following individuals had the following amounts outstanding in the Bills Payable account in the following percentages:

Name	Amount 1953 %		Amount 1954 %		Amount 1955 %	
h Farnsworth	\$ 63,829.80	11.55%	\$ 63,829.80	11.55%	\$	
e Phillips	83,298.60	15.08%	83,298.60	15.08%	147,128.40	26.62%
erine Bernhard	25,000.00	4.52%	25,000.00	4.52%	25,000.00	4.52%
beth McPherson	4,000.00	.72%	4,000.00	.75%	4,000.00	.72%
McPherson	144,000.00	26.06%	144,000.00	26.06%	144,000.00	26.06%
c McPherson	24,000.00	4.34%	24,000.00	4.34%	24,000.00	4.34%
McPherson	99,390.00	17.99%	99,390.00	17.99%	99,390.00	17.99%
McPherson	87,000.00	15.75%	87,000.00	15.75%	87,000.00	15.75%
. Oswalt	6,000.00	1.09%	6,000.00	1.09%	6,000.00	1.09%
hompson	16,000.00	2.90%	16,000.00	2.90%	16,000.00	2.90%
\$552,518.40		100.00%	\$552,518.40		100.00%	\$552,518.40 100.00%

Elizabeth McPherson is the wife of J. McPherson and the mother of J. K. McPherson. Catherine Bernhard is the married daughter of J. McPherson and Elizabeth McPherson and the sister of J. K. McPherson.

23. There is attached hereto and marked Exhibit 20-T and made a part of this stipulation by reference a schedule showing the surplus of the corporation available at the end of each of the years 1915 to 1955, inclusive.

24. There is attached hereto marked Exhibit 21-U and made a part of this stipulation of facts by reference, a schedule showing the dividends paid by the corporation during each of the taxable years 1915 to 1955, inclusive, exclusive of amounts paid and deducted as interest which are in issue.

25. There is attached hereto marked Exhibit 22-V and by this reference made a part of this stipulation of facts, a schedule showing the salaries paid by the corporation during each of the years 1915 to 1955, inclusive. These salaries were paid to

officers of the corporation. No other salaries or wages were paid.

27. There is attached hereto marked Exhibit 24-X and made a part of this stipulation by reference, a balance sheet of the Corporation as of December 31, 1953, as shown by its books.

28. There is attached hereto marked Exhibit 25-Y and made a part of this stipulation by reference, a balance sheet of the Corporation as of December 31, 1954, as shown by its books.

29. There is attached hereto marked Exhibit 26-Z and made a part of this stipulation by reference, a balance sheet of the Corporation as of December 31, 1955, as shown by its books.

30. There is attached hereto marked Exhibit 27-AA and made a part of this stipulation of facts by reference, the description of the farms owned by the Corporation, said farms having been owned by the Corporation from the date of acquisition until the present time and were being held during each of the taxable years 1953, 1954 and 1955.

31. There is attached hereto marked Exhibit 28-BB and by this reference made a part of this stipulation of facts, a letter dated December 11, 1956, addressed to J. K. McPherson, President, State Bank of Wilbur, Wilbur, Washington, signed by R. J. Stole, Vice-President, The National Bank of Commerce of Seattle, located 2nd Avenue at Spring Street in Seattle, Washington.

32. There is attached hereto marked Exhibit 29-CC and made a part of this stipulation by reference, the notes executed by the Wilbur Security

Company on March 10, 1943, on the amounts then outstanding in the Bills Payable Account.

33. There is attached hereto marked Exhibit 30-DD and made a part of this stipulation by reference, the notes executed by the Wilbur Security Company on December 31, 1943, on the amounts then outstanding in the Bills Payable Account.

34. There is attached hereto marked Exhibit 31-EE and made a part of this stipulation by reference, the notes executed by the Wilbur Security Company on December 30, 1944, on the amounts then outstanding in the Bills Payable Account.

35. There is attached hereto marked Exhibit 32-FF and made a part of this stipulation by reference, the notes executed by the Wilbur Security Company on December 31, 1945, on the amounts then outstanding in the Bills Payable Account.

36. There is attached hereto marked Exhibit 33-GG and made a part of this stipulation by reference, the notes executed by the Wilbur Security Company on December 31, 1946, on the amounts then outstanding in the Bills Payable Account.

37. There is attached hereto marked Exhibit 34-HH and made a part of this stipulation by reference, the notes executed by the Wilbur Security Company on December 31, 1947, on the amounts then outstanding in the Bills Payable Account.

38. There is attached hereto marked Exhibit 35-II and made a part of this stipulation by reference, the notes executed by the Wilbur Security Company on December 31, 1951, on the amounts then outstanding in the Bills Payable Account.

39. There is attached hereto marked Exhibit 36-JJ and made a part of this stipulation by reference, the notes executed by the Wilbur Security Company on December 31, 1955, on the amounts then outstanding in the Bills Payable Account.

40. The Internal Revenue Service investigated the income tax returns filed by the Corporation herein for the taxable years 1937 and 1938. The Corporation by and through counsel protested the adjustments asserted by the Revenue Service for said taxable years 1937 and 1938.

41. There is attached hereto marked Exhibit 37-KK and made a part of this stipulation by reference, a letter dated August 2, 1939 sent by the Internal Revenue Service to the Petitioner herein.

42. There is attached hereto marked Exhibit 38-LL and made a part of this stipulation by reference, a letter to the Corporation from the Internal Revenue Service dated October 2, 1939.

43. There is attached hereto marked Exhibit 39-MM and made a part of this stipulation by reference, a letter dated October 26, 1939, from the Acting Internal Revenue Agent in Charge, to the Corporation.

44. There is attached hereto marked Exhibit 40-NN and made a part of this stipulation by reference, a copy of the Protest filed by the Corporation protesting the asserted deficiency in income tax for the year 1937.

45. During both the Excess Profits Tax periods (i.e., World War II and the Korean War), the Corporation treated the amounts outstanding as set

forth in Exhibits 12-L and 19-S as borrowed capital in computing the excess profits tax credit.

46. There is attached hereto marked Exhibit 41-OO and made a part of this stipulation by reference, the minutes of the meeting of the Board of Trustees of the Wilbur Security Company dated January 8, 1952.

47. There is attached hereto marked Exhibit 42-PP and made a part of this stipulation by reference, the minutes of the meeting of the Board of Trustees of the Wilbur Security Company dated November 4, 1952.

48. There is attached hereto marked Exhibit 43-QQ, the original By-Laws of the Corporation.

/s/ PAUL CASTOLDI,

/s/ FRANCIS J. BUTLER,

Counsel for Petitioner.

/s/ ARCH M. CANTRALL, (W.H.P.)

Chief Counsel, Internal Revenue Service, Counsel
for Respondent.

[Endorsed]: T.C.U.S. Filed March 17, 1958.

[Title of Tax Court and Cause.]

SUPPLEMENTAL STIPULATION OF FACTS

This case was tried before the Tax Court in Seattle, Washington on March 17, 1958 and the record was held open until April 16, 1958 to receive a supplemental Stipulation of Facts. Accordingly it is stipulated that the following statements may be

accepted as facts and the attached exhibits made a part of the record in this case.

49. There is attached hereto, marked Ex. 45-RR the minutes of a meeting of the Board of Trustees of Wilbur Security Company dated December 30, 1940.

50. There is attached hereto marked Ex. 46-SS the minutes of a meeting of the Board of Trustees of Wilbur Security Company dated December 30, 1941.

51. There is attached hereto, marked Ex. 47-TT the minutes of a meeting of the Board of Trustees of Wilbur Security Company dated December 31, 1942.

/s/ PAUL CASTOLDI,

Counsel for Petitioner.

/s/ ARCH M. CANTRALL, (W.H.P.)

Chief Counsel, Internal Revenue Service, Counsel
for Respondent.

[Endorsed]: T.C.U.S. Filed April 16, 1958.

31 T. C. No. 92

Tax Court of the United States

Wilbur Security Company, Petitioner, v. Commis-
sioner of Internal Revenue, Respondent.

Docket No. 68408. Filed January 30, 1959

FINDINGS OF FACT AND OPINION

Petitioner's yearly payments, which it designated as interest, on its Bills Payable Account, held, on

the facts of this case, to constitute dividends and not deductible interest.

Held, further, petitioner realized \$840 interest income from an advance it had made to one of its stockholders.

Francis J. Butler, Esq., and Paul Castoldi, Esq., for the petitioner.

George E. Constable, Esq., for the respondent.

Train, Judge: Respondent determined deficiencies in petitioner's income taxes as follows:

Year	Deficiency
1953	\$13,957.26
1954	17,254.17
1955	17,254.18

The issues are (1) whether the amounts outstanding in petitioner's Bills Payable Account, upon which disbursements as interest expense were made during the years involved, constitute bona fide indebtedness of the corporation or whether, in reality, such amounts constitute equity capital invested in petitioner's business; and (2) whether petitioner failed to report interest income in the amount of \$840 on its income and excess profits tax return for 1953.

Findings of Fact

Some of the facts have been stipulated and are hereby found as stipulated.

Petitioner, the Wilbur Security Company, hereinafter referred to as the Company, is a Washington corporation with its principal office located in the city of Wilbur, Washington. Its corporation

income and excess profits tax return for the calendar year 1953 and its corporation income tax returns for the calendar years 1954 and 1955 were timely filed with the district director of internal revenue at Tacoma, Washington.

In 1915, the city of Wilbur, Washington, a small community of less than 1,100 population, was serviced by a single bank, the Wilbur State Bank, hereinafter referred to as the Bank. The stockholders of the Bank had a large amount of money on deposit with the Bank. The stockholders considered that the existence of such large deposits might attract other banking concerns to the city of Wilbur. To forestall such competition from developing, the stockholders of the Bank formed the Company on March 18, 1915. A further purpose of the formation of the Company was to provide an entity which would serve and hold such of the Bank's customers as required long-term loans that the Bank, under existing restrictions, could not carry.

As originally constituted, the Company's Articles of Incorporation provided in part as follows:

Article Two

The objects for which this corporation are formed are:

* * * * *

3. To charge and collect interest upon money loaned, invested or otherwise handled by it, and to derive profit upon any and all transactions by it, and to collect any share of any profit, result or

property involved in any contract or transaction relating to its business.

* * * * *

5. In all ways in its own right, to purchase, acquire, manage, develop, operate, improve, change, exchange, mortgage, lease, pledge, hypothecate, sell and dispose or [sic] properties and interests of all kinds, whether real, personal or mixed and where-soever situate.

6. To take, acquire, purchase, own, sell, lease, exchange, pledge, mortgage, hypothecate, grant, improve and otherwise deal in real estate, townsites and divisions, lots or subdivisions thereof, and to issue evidences of interest, title, or right in any such property, either in its own right or its rights under contract.

* * * * *

9. To borrow or raise money upon all bonds, warrants, debentures, investment certificates and other negotiable or transferable instruments, or otherwise, as directed by the board of trustees.

10. To lend money or other property on its own account and to receive notes, obligations and evidences therefor, and conveyances, hypothecations and pledges as security for its repayment or redelivery of the same.

* * * * *

Article Three

The capital stock of this corporation shall be Twenty-five thousand (\$25,000.00) Dollars, divided

into Two Hundred Fifty (250) shares of the par value of One hundred (\$100.00) dollars per share.

* * * * *

Article Six

The number of trustees of this corporation shall be five and the names and residences of the first trustees who shall manage the affairs of the corporation until the 1st day of July 1915, are J. McPherson, E. L. Farnsworth, Chas. Hudkins, G. Thompson, and E. H. Oswalt, all of Wilbur, Lincoln County, state of Washington.

Article Seven

The capital stock of this corporation may be transferred without restriction to any person already a stockholder therein, but shall not be transferable to any person or party not a stockholder of this company without the affirmative vote, approving such transfer, of at least two-thirds of the capital stock of this company, at a regular or special stockholders' meeting called for that purpose. In case any stockholder desires to sell all or part of the stock held by him to a person not already a stockholder of this company, he shall notify the secretary of this company in writing, stating the amount of stock he desires to sell and the price asked, and shall attach his stock certificate to such notice and give the name and address of the prospective purchaser, the secretary shall then notify all of the other stockholders of this company, and such stockholders shall have an option on said stock

at the price asked for thirty days following such notice. If none of said stockholders shall exercise their right of option at or before the expiration of said thirty days, the secretary of this company shall call a stockholders meeting in the manner provided in the by-laws for the purpose of voting upon such prospective purchaser and in case he shall be elected to become a stockholder of this corporation, the president and secretary thereof shall endorse upon such certificate of stock, under the seal of this corporation, using the form given in Article Eight herein, the fact that such prospective purchaser, naming him, has been duly elected to become a stockholder of this company, and such certificate shall then be returned. In case such prospective purchaser shall not be elected as herein provided, then said certificate shall be returned without such endorsement.

Article Eight

On every certificate of stock issued by this company, the following provision shall be printed thereon, to wit:

According to Article VII of the Articles of Incorporation of this company and an agreement entered into between the holder of this certificate and all the other stockholders of this company, this certificate is not transferable until the stockholders of this company have been given an option for thirty days for the purchase thereof and such option expired, nor can this certificate be transferred, except to the stockholders of this company, without the

consent of at least two-thirds of the capital stock voted in this company, which consent shall be endorsed hereon and signed by the president and secretary of this corporation, naming the person to whom same may be transferred, and bearing the corporate seal.

The following individuals were the original incorporators of the Company and subscribers of the 250 shares of \$100 par value stock authorized by the Company's Articles of Incorporation in the number of shares and amounts indicated:

Subscriber	No. of Shares	Amount
E. L. Farnsworth	120	\$12,000
John McPherson	105	10,500
Charles Hudkins	10	1,000
G. Thompson	10	1,000
E. H. Oswalt	5	500

None of this stock was actually paid for or issued at this time. Petitioner's incorporators subscribed to petitioner's stock in proportion to their stock interests in the Bank.

On April 5, 1915, petitioner's subscribers held a special meeting at which time they each advanced amounts of money to petitioner as "deposits" and adopted the following amendment to the by-laws regarding the aforesaid deposits:

Amendment No. 1

Article XII

The Several stockholder of the Wilbur Security Company having this day deposited with the Company the following amounts;

E. L. Farnsworth	\$96,000.00	
J. McPherson	84,000.00	
Chas. Hudkins	8,000.00	
G. Thompson	8,000.00	
E. H. Oswalt	4,000.00	\$200,000.00

Which sums are to be credited to each Stockholders "Special Stockholders Account" on the books of the Company. These accounts not to be withdrawn by any of said stockholders except by consent of two-thirds of the Capital Stock voted in this Company at any regular or special stockholders meeting.

When any stockholder sells any of his stock it is understood that \$800.00 of his "Special Stockholders Account" shall be transferred with each share of stock sold and the proper officer shall make the transfer on the books of the Company at the time the stock is transferred.

This by-law has never been amended by the corporation.

The \$200,000 advanced to petitioner on April 5, 1915, by its subscribers had been on open account in the Bank to the credit of each subscriber. Upon its advance to the petitioner, this amount was immediately redeposited by it in the Bank.

On December 28, 1916, the petitioner's board of directors held a special meeting at which time it was decided to set aside \$25,000 of petitioner's earnings as paid-in capital. At the same meeting, it was decided to issue stock certificates to the original subscribers thereof. The minutes of the meeting were as follows:

Special meeting of the Trustees of Wilbur Secu-

rity Company held this day and called to order by J. McPherson President at 3:00 P.M. All directors present. The following resolution was offered and unanimously adopted;—

Whereas the earnings of this Company are in excess of Twenty five thousand dollars:

Therefore be it resolved that \$25,000.00 be set aside as the fully paid capital stock of this Company and that certificates of Dividend. stock be issued to the several stockholders as a stock dividend as follows:

E. L. Farnsworth	115	shares
J McPherson	105	“
Chas Hudkins	10	“
G. Thompson	10	“
E. H. Oswalt	5	“
M E Hay	5	“
<hr/>		
Total	250	“

Meeting adjourned.

From 1915 to 1938, the Special Stockholders' Account totaled \$200,000 in each year and the Paid-in Capital Account totaled \$25,000 in each year, representing 250 shares of \$100 par value stock, the only outstanding stock. However, the individual interests in those accounts fluctuated during the period 1915-1938 as follows (the dollar value of the interest in the Special Stockholders' Account appearing first after the year, followed immediately by the number of shares of capital stock):

Year	E. L. Farnsworth	J. McPherson	Elizabeth McPherson	Chas. Hudkins	A. Alexander	G. Thompson	E. Oswalt	M. E. Hay
1915	\$96,000—120	\$ 84,000—105	\$	\$ 8,000—10	\$	\$ 8,000—10	\$ 4,000—5	
1916	92,000—115	84,000—105		8,000—10		8,000—10	4,000—5	4,000—5
1917	92,000—115	80,000—100		12,000—15		8,000—10	4,000—5	4,000—5
1918	92,000—115	80,000—100		12,000—15		8,000—10	4,000—5	4,000—5
1919	60,000—75	80,000—100		24,000—30	4,000—5	16,000—20	12,000—15	4,000—5
1920	60,000—75	80,000—100		24,000—30	4,000—5	16,000—20	12,000—15	4,000—5
1921	64,000—80	80,000—100		24,000—30		16,000—20	12,000—15	4,000—5
1922	72,000—90	80,000—100	4,000—5	24,000—30		16,000—20	4,000—5	
1923	76,000—95	80,000—100	4,000—5	20,000—25		16,000—20	4,000—5	
1924	76,000—95	80,000—100	4,000—5	20,000—25		16,000—20	4,000—5	
1925	76,000—95	80,000—100	4,000—5	20,000—25		16,000—20	4,000—5	
1926	76,000—95	100,000—125	4,000—5	20,000—25		16,000—20	4,000—5	
1927	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1928	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1929	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1930	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1931	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1932	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1933	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1934	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1935	76,000—95	100,000—125	4,000—5			16,000—20	4,000—5	
1936	72,000—90	102,000—127½	4,000—5			16,000—20	6,000—7½	
1937	72,000—90	102,000—127½	4,000—5			16,000—20	6,000—7½	
1938	72,000—90	102,000—127½	4,000—5			16,000—20	6,000—7½	

In addition to the \$200,000 in the Special Stockholders' Account, petitioner received various additional sums from 1915 through 1938. These amounts were received from the original subscribers, from stockholders and from nonstockholders. In every case, however, such nonstockholders were members of the immediate families of stockholders. The accumulation of these amounts and their source during the years 1915 to 1938 was as follows:

Nonstockholders did not participate in management or in voting for petitioner's officers. The \$200,000 in the Special Stockholders' Account, the \$25,000 in the Paid-in Capital Account, and the monies in the Special Account were invested in loans upon notes and mortgages, primarily upon real estate, in which the Bank was unable to invest. When some of the obligors could not meet the payments on the notes and mortgages, petitioner acquired title to the properties which had been held as the security for the loans. As a result petitioner acquired title to the following properties:

Description	Date Acquired	Acreage
Alexander Farm	1929 to 1933	2,781
Cameron Farm	1933	627
Edd Campbell Farm	1932	547
Grinstead Farm	1933	158
Hagen Farm	1933	315
John Hansen Farm	1932	470
B. L. Harris Farm	1932	1,098
F. A. Hudkins Farm	1932	145
Frank Nelson Farm	1931 and 1932	938
O'Shaughnessy Farm	1932	478
Osterkamp Farm	1935	1,579
Smith-Draper Farm	1932	474
	1953 less sale	20
		— 454
V. Sommers Farm	1933	359
V. Sommers Farm	1931 and 1932	621
E. A. Squire Farm	1933	79
E. A. Squire Farm	1932	1,157
R. S. Stauffer Pasture Land	1933	742

The combined book value of these farms was from \$437,039.41 to \$445,594.72, whereas the fair market value of the properties was estimated to be in excess of \$1,500,000 during the years in question. The op-

eration of these farms constituted petitioner's principal source of income.

Petitioner's surplus, dividends, salaries, interest paid on obligations not in issue, and amounts paid on the Special Account and Special Stockholders' Account from 1915 through 1938 were as follows:

Year	Surplus	Dividends	Salaries	Interest Paid on Obligations not in Issue	Amts. Paid on Spec. Acct. and Special Stockhold- er's Acct.
1915	\$ 5,058.53	\$ None	\$ None	\$ None	\$ 388.77
1916	2,228.81	25,000.00	None	None	3,701.45
1917	728.69	18,000.00	7,840.00	None	4,837.50
1918	105.43	20,000.00	6,480.00	100.00	6,279.20
1919	792.46	17,500.00	4,400.00	1,335.72	7,714.30
1920	1,876.19	7,500.00	4,400.00	8,253.93	8,770.00
1921	19,122.53	None	2,400.00	4,993.09	12,645.40
1922	18,142.34	None	4,675.00	654.60	13,341.60
1923	18,422.58	None	None	623.67	14,902.19
1924	17,855.34	None	None	118.68	12,595.15
1925	17,384.09	2,500.00	None	150.00	13,255.67
1926	21,542.22	5,000.00	None	1,348.42	13,339.12
1927	36,219.85	None	None	475.00	13,684.36
1928	48,901.34	None	None	None	12,552.66
1929	49,969.10	None	None	570.87	12,841.30
1930	53,776.75	None	None	3,152.70	13,044.00
1931	53,063.90	None	None	1,831.88	5,607.93
1932	49,636.64	None	None	1,984.60	None
1933	49,486.08	None	None	387.33	None
1934	48,861.34	None	None	80.83	None
1935	47,689.40	None	None	None	None
1936	48,675.20	None	None	None	None
1937	48,685.46	12,500.00	2,200.00	1,172.38	15,760.00
1938	48,687.22	9,585.00	None	None	16,428.00

In 1939, petitioner's income tax returns for 1937 and 1938 were examined by respondent and a defi-

ciency in income tax was proposed for that year on the basis of a disallowance of the interest deduction taken for the interest paid to the stockholders on the amounts in the Special Stockholders' Account. Petitioner filed a protest to the proposed determination and a subsequent agreement was reached whereby the tax returns were accepted as correct.

On June 5, 1939, a special meeting of petitioner's stockholders was held in which a resolution was adopted. The minutes of the meeting were, in part, as follows:

It was duly moved, seconded and carried unanimously that the Stockholders Accounts on books of Wilbur Security Company, which total \$200,000.00 shall be paid off and distributed to the owners thereof, viz:

J. McPherson,	Stockholders Account	\$102,000.00
E. L. Farnsworth,	Stockholders Account	72,000.00
G. Thompson,	Stockholders Account	16,000.00
E. H. Oswalt,	Stockholders Account	6,000.00
Elizabeth McPherson	Stockholders Account	4,000.00
		<hr/>
		\$200,000.00

and further, that the Secretary of Wilbur Security Company, G. Thompson, is hereby directed and empowered to pay off and distribute the said Stockholders Accounts to the owners thereof.

The \$200,000 was withdrawn from the Special Stockholders' Account and the same amount was redeposited with the other funds in the Special Account. This transaction was accomplished by book-

keeping entries without transferring cash between petitioner and the stockholders. From this time on, only stockholders and members of the immediate families of stockholders held interests in the Special Account.

On January 20, 1943, petitioner's board of directors passed a resolution which provided, in part, as follows:

It was duly moved, seconded and carried that all our Special Accounts Payable, on which we pay interest, shall be changed over to Bills Payable, as of January 1, 1943. That the Secretary shall prepare proper notes of the Wilbur Security Company for each of said Special Accounts Payable, dating same January 1, 1943, due one year after date, and bearing interest at rate of 5 per cent per annum. That, these said Bills Payable shall be signed for the Company by the its [sic] President and attested by its Secretary.

Following this action, the Secretary prepared bills payable to the respective holders of interests (who were all stockholders or members of their immediate families) in the new Bills Payable Account, to pay five per cent interest for one year. At the end of each year thereafter, up to 1955, petitioner's directors renewed these bills to pay a specified rate of interest or cancelled the old notes and issued new notes for the same amounts without approval from those nonstockholders who held interest in the Bills Payable Account. The directors endeavored

to fix the interest rate annually so that it would be slightly above that of the prevailing rate paid by lending institutions. At the same time, in fixing the annual interest rate, the directors took into account the petitioner's earnings. The notes remained in petitioner's possession at all times and none of the nonstockholders ever saw them, although some knew of them.

The notes executed for 1952, on December 31, 1951, were originally issued to provide for five per cent interest per annum. On November 4, 1952, the board of directors increased this interest rate to six per cent. In 1956 the nomenclature of this account was changed to Notes Payable at the advice of Laurence D. Morse, the certified public accountant who handled the books of petitioner, because the term Bills Payable was deemed to be old-fashioned.

The status of the Bills Payable Account from 1939 to 1955 and a comparison of that account to the stock account for those years were as follows:

Year	E. L. Farnsworth	Sarah A. Farnsworth	Grace Phillips	J. McPherson	G. Thompson
1939	\$169,790.55—90	\$		\$190,000.00—1221½	\$16,000.00—20
1940	157,790.55—90			187,000.00—1221½	16,000.00—20
1941	81,081.47	73,096.74—90		171,000.00—1021½	16,000.00—20
1942		99,829.80—90	44,298.60	144,000.00—1021½	16,000.00—20
1943		96,829.80—90	50,298.60	144,000.00—1021½	16,000.00—20
1944		93,829.80—90	53,298.60	144,000.00—1021½	16,000.00—20
1945		90,829.80—90	56,298.60	144,000.00—1021½	16,000.00—20
1946		75,829.80—90	71,298.60	144,000.00—1021½	16,000.00—20
1947		72,829.80—90	74,298.60	144,000.00—1021½	16,000.00—20
1948		69,829.80—90	77,298.60	144,000.00—1021½	16,000.00—20
1949		66,829.80—90	80,298.60	144,000.00—1021½	16,000.00—20
1950		63,829.80—90	83,298.60	144,000.00—1021½	16,000.00—20
1951		63,829.80—90	83,298.60	144,000.00—1021½	16,000.00—20
1952		63,829.80—90	83,298.60	144,000.00—1021½	16,000.00—20
1953		63,829.80—90	83,298.60	144,000.00—1021½	16,000.00—20
1954		63,829.80—90	83,298.60	144,000.00—1021½	16,000.00—20
1955			147,128.40—90	144,000.00—1021½	16,000.00—20

Year	E. H. Oswalt	Elizabeth McPherson	J. K. McPherson	Kate McPherson	Julia McPherson	Catherine Bernhard
1939	\$6,000.00—7½	\$4,000.00—5	\$ 8,000.00—5	\$87,000.00	\$99,390.00	\$
1940	6,000.00—7½	4,000.00—5	8,000.00—5	87,000.00	99,390.00	
1941	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	
1942	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1943	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1944	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1945	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1946	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1947	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1948	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1949	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1950	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1951	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1952	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1953	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1954	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1955	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00

The monies in the Grace Phillips account prior to 1940 were deposited there for her by E. L. Farnsworth, her father, who took care of her finances. In 1940, E. L. Farnsworth died and his stock, plus an amount in excess of \$800 per share, was then transferred to the account of Sarah A. Farnsworth, his widow. Of the remaining funds left in the Special Account to the account of E. L. Farnsworth, approximately \$69,000 were used to pay inheritance taxes. Sarah A. Farnsworth died in 1951. Her stock and interest in the then Bills Payable Account were held under that name until 1954 when they were transferred to the account of Grace Phillips, her daughter. On January 1, 1953, petitioner disbursed \$14,000 to Grace Phillips, as executrix of the Estate of Sarah A. Farnsworth, for the purpose of settling that estate. No book entry was made affecting the balance in the Bills Payable Account, or any other account. However, the interest payment on the Bills Payable Account was arrived at by subtracting the \$14,000 from the Bills Payable Account and computing the interest on the difference. The total of Bills Payable for the year was also shown as the gross amount undiminished by the \$14,000 on the balance sheet, but the minutes of the directors' meeting and the 1953 tax return reflect both the gross amount and the net amount in that account. The \$14,000 was redeposited with petitioner on January 4 and 12, 1954, by Grace Phillips to the credit of the estate.

The relationship between stockholders, and between stockholders and those owning interests in the Bills Payable Account was as follows:

D. K. McPherson	
J. McPherson	Son of D. K. McPherson
Kate McPherson	Daughter of D. K. McPherson
Julia McPherson	Daughter of D. K. McPherson
Elizabeth McPherson	Wife of J. McPherson
J. K. McPherson	Son of J. McPherson
Catherine Bernhard	Daughter of J. McPherson
E. L. Farnsworth	
Sarah A. Farnsworth	Wife of E. L. Farnsworth
Grace L. Phillips	Daughter of E. L. Farnsworth

The members of the McPherson and Farnsworth families have maintained a close, friendly relationship through the years.

From 1941 to 1955 the members of the board of trustees (or directors) consisted of five of the stockholders, as provided for by the by-laws. These were:

John McPherson	Godfrey Thompson
John K. McPherson	Grace L. Phillips
E. H. Oswalt	

Petitioner's officers from 1941 to 1955 were as follows:

John McPherson	President
J. K. McPherson	Vice President
Godfrey Thompson	Secretary

Petitioner's surplus, dividends, salaries, interest paid on obligations not in issue, and interest paid on the Special Account or Bills Payable Account from 1939 through 1955 were as follows:

Year	Surplus	Dividends	Salaries	Interest Paid on Obligations not in Issue	Amts. Paid on Spec. Acct. or Bills Pay- able Acct.
1939	\$ 51,367.39	\$ 5,000.00	\$ None	\$ None	\$17,016.90
1940	52,734.52	7,500.00	None	None	17,195.40
1941	56,741.77	7,500.00	None	203.33	21,559.50
1942	75,819.90	7,500.00	5,000.00	162.90	27,475.92
1943	69,140.93	7,500.00	5,000.00	None	27,596.75
1944	73,864.99	7,500.00	5,000.00	None	27,625.92
1945	79,082.44	7,500.00	5,000.00	None	27,625.92
1946	84,553.48	25,000.00	8,000.00	None	27,625.92
1947	98,158.21	25,000.00	12,000.00	None	27,625.92
1948	105,328.30	25,000.00	18,000.00	None	27,625.92
1949	109,838.21	25,000.00	18,000.00	None	27,625.92
1950	128,977.48	25,000.00	18,000.00	None	27,625.92
1951	129,107.95	25,000.00	18,000.00	None	27,625.92
1952	147,238.25	25,000.00	18,000.00	None	33,151.10
1953	147,541.62	25,000.00	18,000.00	None	32,311.10
1954	164,121.39	25,000.00	18,000.00	None	33,151.10
1955	166,872.50	25,000.00	18,000.00	None	33,151.10

Petitioner's balance sheet for the years in question was as follows:

	1953	1954	1955
ASSETS			
Current Assets			
Cash in bank	\$ 2,315.55	\$ 54,938.74	\$ 35,119.82
Bills Receivable	304,095.73	269,161.64	283,176.36
Investment in Stocks	500.00	500.00	500.00
Fixed Assets			
Farm properties and buildings	438,148.74	437,039.41	445,594.72
Total assets	<u>\$745,060.02</u>	<u>\$761,639.79</u>	<u>\$764,390.90</u>

LIABILITIES AND CAPITAL

Current Liabilities

	1953	1954	1955
Income tax payable, estimated	\$ 20,000.00	\$ 20,000.00	\$ 20,000.00
Notes payable	552,518.40	552,518.40	552,518.40

Capital

Capital stock	25,000.00	25,000.00	25,000.00
Surplus	147,541.62	164,121.39	166,872.50

Total liabilities and capital	\$745,060.02	\$761,639.79	\$764,390.90
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Respondent disallowed all interest deductions for monies paid as interest on the Bills Payable Account when he determined that the account represented the actual invested capital, placed at the risk of the enterprise. Also the amount of \$840 was added to petitioner's income for 1953 representing six per cent interest on the \$14,000, which was reported as an account receivable from the Estate of Sarah A. Farnsworth.

The amounts outstanding in petitioner's Bills Payable Account constitute equity capital invested in the petitioner's business. The payments of \$32,311.10 in 1953, \$33,151.10 in 1954, and \$33,151.10 in 1955 on the Bills Payable Account were distributions of dividends.

Petitioner did not realize \$840 in interest income in 1953.

Opinion

Issue 1.

Whether amounts advanced to a corporation constitute equity capital or indebtedness is a question of fact, and the issue must be decided on the facts of each individual case. *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946). Under the decided cases, some of the determining factors have been the name given to the certificates evidencing the indebtedness, the presence or absence of a maturity date, the source of the payments, the right to enforce the payment of principal and interest, participation in management, a status equal to or inferior to that of regular corporate creditors, the intent of the parties, capitalization, identity of interest between creditor and stockholder, and payment of interest only out of dividends. See *Gooding Amusement Co.*, 23 T.C. 408 (1954), *affd.* 236 F.2d 159 (C.A. 6, 1956), *certiorari denied* 352 U.S. 1031 (1957); *Isidor Dobkin*, 15 T.C. 31 (1950); *Green Bay & Western Railroad Co.*, 3 T.C. 372 (1944), *affd.* 147 F.2d 585 (C.A. 7, 1945); and *John Kelley Co.*, 1 T.C. 457 (1943), *revd.* 146 F.2d 466 (C.A. 7, 1944), *revd.* 326 U.S. 521 (1946). It is the petitioner's contention that a consideration of the above-listed factors as they existed during the years before us, 1951-1953, leads to the conclusion that a bona fide indebtedness existed. On the other hand, respondent maintains that giving proper consideration and weight to all material facts and circumstances, including those of years prior to the tax

years, will require a contrary result. We agree with respondent.

Looking only to the facts of the years in question, without regard to the circumstances of prior years, the Bills Payable Account might appear to be a bona fide indebtedness. For each account, there existed a note, bearing a stated rate of interest, and payable at a fixed maturity date, one year from the date of making the note. The ownership of the stock did not continue in the same proportion to the interests in the Bills Payable Account. Some persons owning interests in the Bills Payable Account did not own any stock, nor did they have any right to vote or participate in the management. The names on the certificates, Bills Payable, suggest an indebtedness rather than capital investment. Finally, the declared intent of the petitioner as set out in the minutes of the directors' meetings would suggest the existence of an indebtedness. However, we are satisfied that to accord determinative weight to these apparent indicia of an indebtedness without consideration of the events and circumstances of prior years, where material, would distort the true facts and obscure the reality of the arrangement here involved.

In 1915, when the corporation was first formed, the only funds petitioner possessed with which it could conduct its business was the \$200,000 advanced by the subscribers to the stock. No other property or capital was advanced to it. No stock was issued or paid for in 1915. This same \$200,000 was part of the Bills Payable Account during the years here

involved, 1953-1955. On April 5, 1915, the by-laws were amended whereby the stockholders were required to have \$800 in the Special Stockholders' Account (now part of the Bills Payable Account) for each share of stock owned by them. It was not until 1916 that the subscribed stock was in fact issued, and this subscribed stock was paid for from the first year's earnings of the business. During that year, only the \$200,000 was available and at the risk of the business so that we may conclude that the stock was paid for out of earnings on the \$200,000. In 1916, a "stock dividend" was declared in the amount of \$25,000 (the same amount as that of the original, unpaid-for stock subscriptions) and this \$25,000 was then set aside as the paid-in capital on the company books. Thus, it is obvious from these circumstances that the \$25,000 in reality represented earned surplus rather than actual paid-in capital. The original \$200,000 remained the sole risk capital of the enterprise. The ratio of the stated capital of \$25,000 to the so-called Special Stockholders' Account of \$200,000 was eight to one, a fact indicative that the entire \$200,000 was at the risk of the business. See *R. M. Gunn*, 25 T.C. 424 (1955), *affd.* 244 F. 2d 408 (C.A. 10, 1957), *certiorari denied* 355 U.S. 830 (1957); and *Gooding Amusement Co.*, *supra*. In the first years of petitioner's existence, there was no written evidence of the alleged indebtedness, no obligation to pay interest, no maturity date, no right to enforce payment of interest or principal, and there was an absolute proportionate interest between stock and the

Special Stockholders' Account, required by the by-laws, which continued through 1939.

The \$200,000 had been withdrawn originally from the Bank for the purpose of using it to make long-term loans, which the Bank could not make because of loan restrictions. Petitioner also argues that the stockholders originally withdrew the \$200,000 from the Bank because the presence of the large deposit on hand at the Bank would lure other competing banks into the small community. However, once the money was withdrawn from the Bank and advanced to petitioner, it was immediately redeposited in the Bank to the account of petitioner. In view of this circumstance, it is difficult to find much substance in the argument.

Under all the circumstances of this case, we are satisfied that there was no separate identity between the stated capital and the loan account of \$200,000. In fact, the stated capital owes its very existence to the loan account.

In 1939, the \$200,000 Special Stockholders' Account was transferred to the Special Account. Petitioner contends that the Special Stockholders' Account was liquidated at that time and that the stockholders then chose to reloan the money to petitioner. However, aside from the resolution passed at a meeting of the stockholders in 1939, there is no record of the amounts being distributed in fact to the interested parties, but there was merely an entry on the books whereby the Special Account was credited and the Special Stockholders'

Account was debited. It is significant that petitioner made these entries only after respondent had examined its books and questioned the claimed interest payments on the \$200,000. Moreover, the proportionate interest of stock to the original loan, now part of the Special Account, continued following the bookkeeping changes in 1939. For every share of stock held, there remained \$800 in the Special Account to the account of the particular stockholder.

In 1943, petitioner converted the Special Account to the Bills Payable Account at the advice of its accountant. For the first time, notes were made reflecting the amounts in the account. These notes bore a stated rate of interest, and a maturity date of one year from the date they were made. However, these notes remained in the possession of the petitioner, and no nonstockholder saw them, although some knew of their existence. At the end of each year, either the notes were marked paid by one of petitioner's officers and new notes issued for the same amount, or the old notes were simply renewed. These transactions were accomplished without the concurrence of those, other than stockholders, owning interests in the Bill Payable Account. The interest rate actually varied from year to year and this variation took into consideration the earnings of the business during the year prior to the date the notes were made. In 1952 the notes were altered by the petitioner, two months before the payment date, without conferring with the persons who held interests in the Bills Payable Account, so

as to increase the amount of interest payable at the maturity date of the notes. The similarity of this action to the declaration of an extra, or year-end, dividend seems more than coincidental.

We note that the account of Sarah A. Farnsworth in the Bills Payable Account during the years 1948-1954 did not have \$800 for each share of stock held by Sarah A. Farnsworth or her estate. The account did have at least \$709.22 for each share of stock owned by Sarah A. Farnsworth or her estate. However, Grace Phillips, the daughter of Sarah A. Farnsworth and the individual who conducted the business affairs of her mother, had sufficient amounts to her own credit in the account to equal the required \$800. Grace Phillips was a member of the board of directors from 1941 through the years in question, although she was not an actual stockholder until 1955 when stock was transferred to her account from her mother's estate. Under these circumstances and in view of the great weight of the other evidence, the fact of Sarah A. Farnsworth's somewhat disproportionate interests, is insufficient to alter our conclusion that the \$200,000 represented equity capital.

As we have found, from 1915 through the years in question, amounts were deposited with petitioner in addition to the original \$200,000 and some of these amounts were placed to the credit of persons other than stockholders. However, the only non-stockholders having such credits were members of the Farnsworth and McPherson families, these two families controlling at least two-thirds of the cor-

porate stock at all times. Aside from the absence of voting rights and participation in management, there were no distinctions between the \$200,000 account and the Special Account. However, the lack of voting rights and participation in management is also common to certain kinds of stock. *Green Bay & Western Railroad Co.*, *supra*; *Commissioner v. H. P. Hood & Sons*, 141 F. 2d 467 (C.A.1, 1944), affirming *H. P. Hood & Sons, Inc.*, a Memorandum Opinion of this Court filed December 2, 1942. When the Special Stockholders' Account and the Special Account were combined in 1939, it did not affect the nature of the Special Account any more than it did the nature of the amounts previously in the Special Stockholders' Account. The issuance of the notes on the Bills Payable Account in 1943 likewise did not affect the nature of the account, since there were no changes as to control, rights to interest and recovery, or as to true maturity date. As was the case with respect to the original \$200,000, the rate of interest varied from year to year at the discretion of the board of directors who took into account the petitioner's earnings in fixing the rate. We are satisfied that the effect of the written notes, the stated maturity dates, interest rates and the disproportionate interest of stock to the Bills Payable Account served only to disguise the true nature of the amounts in that account. The amounts held by petitioner in the Bills Payable Account, above the original \$200,000 capital of the corporation, represent additional capital, and were at the risk of the business.

The amounts paid on the Bills Payable Account during the years in question constituted dividends and not deductible interest.

Issue 2.

Respondent has determined that petitioner realized \$840 interest income in 1953 on the \$14,000 outstanding loan to the Estate of Sarah A. Farnsworth. Petitioner argues that it did not charge any interest to the estate and is not required to do so for income tax purposes. *Combs Lumber Co.*, 41 B.T.A. 339 (1940). Nor is it required to accrue interest, where there existed an understanding that none would be charged, even though there existed a note bearing a stated interest rate. *Society Brand Clothes, Inc.*, 18 T.C. 304 (1952). However, here there was no note, and we conclude, consistent with the rest of this opinion, that the \$14,000 represented simply a withdrawal of capital, later reinvested. This being the case, petitioner is not chargeable with having realized interest income on that amount.

Decision will be entered under Rule 50.

Served February 2, 1959.

[Title of Tax Court and Cause.]

ORDER

It is

Ordered: That the second paragraph of the Headnote of the Findings of Fact and Opinion herein,

31 T.C. No. 92, filed January 30, 1959, be and it hereby is amended as follows:

Held, further, petitioner did not realize \$840 interest income from amount temporarily withdrawn by one of its stockholders.

Dated: Washington, D. C., February 4, 1959.

[Seal] /s/ RUSSELL E. TRAIN,
Judge.

Served February 6, 1959.

Tax Court of the United States
Washington

Docket No. 68408

WILBUR SECURITY COMPANY,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the Findings of Fact and Opinion filed January 30, 1959, the respondent and petitioner herein having filed an agreed computation on March 10, 1959, now therefore, it is

Ordered and Decided: That there are deficiencies in income tax for the taxable years 1953, 1954, and

1955 in the amounts of \$13,520.46, \$17,254.17, and \$17,254.18, respectively.

Entered: March 13, 1959.

[Seal] /s/ RUSSELL E. TRAIN,
Judge.

Served March 16, 1959.

In The United States Court of Appeals
For The Ninth Circuit

Tax Court Docket No. 68408

WILBUR SECURITY COMPANY,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REVIEW

Wilbur Security Company, Petitioner in this cause, hereby files a Petition for Review by the United States Court of Appeals for the Ninth Circuit of the decision by the Tax Court of the United States entered March 13, 1959 (Opinion filed January 30, 1959, Amended February 4, 1959) reported at 31 T.C. . . . , No. 92, determining deficiencies in Petitioner's federal income taxes for the taxable years 1953, 1954, and 1955, in the amounts of \$13,957.26, \$17,254.17, and \$17,254.18, respectively. This

Petition for Review is filed pursuant to provisions of Sections 7482 and 7483 of the Internal Revenue Code. The Petitioner respectfully shows as follows:

I.

Allegations of Venue

Petitioner is a Washington corporation with its principal office located in the City of Wilbur, Washington. For each of the taxable years 1953, 1954, and 1955, Petitioner timely filed its corporate tax returns with the District Director Internal Revenue at Tacoma, Washington. Venue is conferred upon the Circuit Court of Appeals for the Ninth Circuit by virtue of the above facts and Section 7482(b) of the Internal Revenue Code.

II.

Nature of The Controversy

This case involves the oft litigated question of the deductibility, for federal income tax purposes, of certain payments made by Petitioner in each of the taxable years 1953, 1954, and 1955, i.e., whether such payments represent nondeductible dividends or whether the payments represented interest which Petitioner could deduct in arriving at taxable income for the said years. The facts underlining the controversy are as follows:

Wilbur Security Company was organized in 1915 as a Washington corporation with its principal office in Wilbur, Washington. Its authorized capital was \$25,000. At the time of incorporation, \$200,-

000 was deposited with the corporation in a "Special Stockholders' Account". From 1915 to 1938 the "Special Stockholders' Account" remained on the books of the corporation. In addition to the \$200,000 in the "Special Stockholders' Account", the Petitioner borrowed other moneys from stockholders and other individuals. In 1938 the total advances to the Petitioner, over and above the said \$200,000, was \$356,230.55, which said amount was placed in an account labeled "Special Account".

In 1939 the said "Stockholders' Account" and the "Special Account" were consolidated under the heading of "Special Account" and the amounts remained in this account until 1942. In 1942 the amount outstanding in the "Special Account" was approximately \$549,518.40, of which \$293,829.80 had been obtained from stockholders of the company and \$255,688.60 was obtained from persons who owned no stock interest in the Petitioner.

In 1943 the said "Special Account" was changed to "Bills Payable". Notes were issued to the owners of the funds in the said "Bills Payable" account carrying interest at the rate of five per cent (5%) and calling for payment in one year. Notes evidencing the amounts in the "Bills Payable" account were in existence during each of the taxable years 1953, 1954, and 1955, and interest was paid annually by the Petitioner on the said amounts.

The amount outstanding in the "Bills Payable" account during each of the taxable years 1953, 1954, and 1955, was \$552,518.40. Of this amount, some 53.34 per cent had been advanced by persons who

were not stockholders in the Petitioner and had no voice in the management and did not share in the earnings of the Petitioner. During the taxable years 1953, 1954, and 1955, the ownership in Petitioner's stock and bills payable was not proportionate.

Petitioner always treated the amounts outstanding in the "Bills Payable" account as loans. This consistent treatment was maintained even during the excess profits tax years when it would have been advantageous tax-wise to treat the amounts as paid-in capital. The amounts in the "Bills Payable" account were never subordinate to other creditors. During each of the taxable years 1953, 1954, and 1955, the fair market value of the assets of the Petitioner was in excess of \$1,500,000.

In 1953, one of the stockholders died. At this time the stock of the Petitioner, for estate tax purposes, was valued at \$2,300 a share. The value was agreed to between the Internal Revenue Service and the deceased stockholder's estate.

For the taxable years 1937 and 1938, an agent of the Internal Revenue Service disallowed, for tax purposes, the interest deductions to the Petitioner on the amounts then outstanding in the stockholders' account. The Internal Revenue Service took the position that the amounts paid as interest on this account were, in fact, dividends. After conference with the Appellate Division, the Internal Revenue Service accepted the tax returns as filed by the Petitioner for the said taxable years.

In 1953, 1954, and 1955, the Internal Revenue Service again took the position that the interest

payments were not deductible by Petitioner in arriving at taxable income. A deficiency in tax was asserted for the said taxable years based principally upon the disallowance of the interest as a deduction.

The Tax Court of the United States held that the entire amount outstanding in the Petitioner's "Bills Payable" account for each of the years 1953, 1954, and 1955, constituted equity capital invested in the Petitioner's business and that the amounts paid by the Petitioner on this account, and deducted as interest, were in fact the distribution of a dividend.

III.

The said taxpayer-corporation being aggravated by the Findings of Fact and Conclusions of Law contained in the Findings and Opinion of the Tax Court, as referred to above, and by its Decision entered pursuant thereto, desires to obtain a review thereof by the United States Court of Appeals for the Ninth Circuit.

The interest payments made by the corporation in each of the taxable years, 1953, 1954, and 1955, were deductible by the Petitioner in arriving at taxable income and the amounts outstanding in the "Bills Payable" account during each of those said taxable years represented loans to the company and not equity capital.

/s/ PAUL CASTOLDI,

/s/ FRANCIS J. BUTLER,

Counsel for Petitioner.

Duly Verified.

I, Francis J. Butler, one of the counsel of record for the Petitioner in the within proceeding, do hereby certify that I served a true copy of the Petition for Review on Arch M. Cantrall, Chief Counsel, Internal Revenue Service, Washington, D. C., by mailing to him on this date a true copy thereof, addressed to him at such address.

/s/ FRANCIS J. BUTLER.

Subscribed and sworn to before me this 21st day of April, 1959.

[Seal] /s/ WILLIAM G. ENNIS,
Notary Public in and for the State of Washington,
residing at Spokane.

[Endorsed]: T.C.U.S. Filed April 24, 1959.

[Title of Tax Court and Cause.]

CERTIFICATE

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 18 inclusive, constitute and are all of the original papers on file in my office as called for by the "Designations", including exhibits 1-A through 22-V and 24-X through 43-QQ attached to the stipulation of facts, joint exhibit 23-W, admitted in evidence, petitioner's exhibit 44, admitted in evidence, and exhibits 45-RR through 47-TT attached to the supplemental stipulation of facts, in the case before the Tax Court of the United

States docketed at the above number and in which the petitioner in the Tax Court has filed a petition for review as above numbered and entitled, together with a true copy of the docket entries in said Tax Court case, as the same appear in the official docket in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 26th day of May, 1959.

[Seal] /s/ HOWARD P. LOCKE,
Clerk, Tax Court of the
United States.

The Tax Court of the United States

Docket No. 68408

WILBUR SECURITY COMPANY,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

TRANSCRIPT OF PROCEEDINGS

Courtroom 815, United States Courthouse, Seattle, Washington, Monday, March 17, 1958.

The above-entitled matter came on for hearing, pursuant to notice at 2:45 o'clock p.m.

Before: The Honorable Russell E. Train.

Appearances: Francis J. Butler, Esq., and Paul Castoldi, Esq., 811 Paulsen Building, Spokane, Washington, appearing for the petitioner. George E. Constable, Esq., 211 U. S. Courthouse, Seattle, Washington, appearing for the respondent. [1]*

Proceedings

The Clerk: Docket No. 68408, Wilbur Security Company.

Mr. Constable: Your Honor, George E. Constable for respondent.

We have considerable data, we have a lengthy stipulation of fact which I think is ready. I wonder if we may have five minutes to assemble this data.

The Court: The Court will stand in recess for ten minutes.

(Short recess.)

The Clerk: The Court will proceed with the trial of Docket No. 68408, Wilbur Security Company.-

Mr. Butler: Mr. Paul Castoldi and Francis J. Butler appearing on behalf of petitioner.

Mr. Constable: George E. Constable for respondent.

Mr. Butler: If it please the Court, we have a rather voluminous stipulation of facts and also a deposition that has been taken pursuant to stipulation of the parties. I thought it might be a good idea, since Your Honor hasn't this stipulation of facts, to give you a short opening statement.

The Court: Proceed.

* Page numbers appearing at top of page of Reporter's Transcript of Record.

Opening Statement On Behalf of the Petitioner by
Mr. Butler:

Your Honor, this case involves the taxable years 1953, '54, and '55. The principal issue is one that I am sure the Court is familiar with, the disallowance of an [3] interest payment on certain amounts outstanding in which the question is, the old question of thin incorporation. Fortunately we are not bothered by any voluminous statutory provisions because it is all case law, there is nothing in the statute on it.

The only other minor issue concerns an interest payment of \$850. We have pleaded that small depreciation issue in the petition, which we are not contesting. The deficiency is somewhere in the neighborhood of \$50,000, but it is more than that really because it is a continuing issue, one which is extremely important to the petitioners herein.

Of course, since it is strictly a factual situation, there are a great number of cases that have been decided on it and each one has its own peculiar facts. This case is certainly no exception in that. The only thing you can do is glean certain things from those cases by way of facts. I would say that we think that the certain elements set out in the case law are very favorable to our position.

I would just briefly like to state a rough outline of the facts for the Court.

This isn't a Kelly-Talbot type case where there is any question of whether the notes or the evidences

of indebtedness have any indicia of ownership, it is a strict, as I see it, pure thin incorporation question, there is no doubt about what the notes provide, they're stipulated in evidence. [4]

In 1950, which was some 18 months after the first Internal Revenue Code of 1913 was enacted, the corporation, Wilbur Security Company, was organized. It was organized by some gentlemen who were also interested in a small bank in the City of Wilbur in the State of Washington. Stock was subscribed for but not issued until 1916. At this time there was a dividend paid and \$25,000 of capital was paid in. They deposited at that time \$200,000 in what comes to be known in the stipulated facts as a stockholders' special account. This special account, this \$200,000, remained on deposit with the Wilbur Security Company until 1938. In the meantime through the years the corporation obtained other amounts which are also a subject of the stipulated facts, or/and above the \$200,000, and the additional amounts which had been obtained from certain individuals were consolidated into what became known as a special account, and that account remained unchanged until sometime in 1942, as the stipulated facts will show, the nomenclature of this account was changed over to what becomes known in the stipulated facts as the bill payable account, the same balances having been transferred over per books by cash.

Of course at that time in 1943, notes were issued evidencing the amounts outstanding in that account,

also, I might add, calling for a time certain payment and an interest payment. These notes were renewed through the years. Some years they were, in the later years they were merely [5] re-issued without tearing up the old note or anything, but nonetheless, the notes were in issue outstanding all these years. Interest was paid on these amounts.

In 1938 this same question of thin incorporation was before the then technical staff and they resolved the question in favor of the taxpayers.

I think that the facts will show that the intent of these people in putting this money up was quite clear that they intended that the money come back and it wasn't at the risk of the business, wasn't subordinate to other amounts, and, furthermore, they had every reason to believe it would come back. I don't think, despite the theory of the case, that there is any thinness. In 1952, for example, the book value or the fair-market value of the assets of this company were, as we will show, in excess of a million dollars. The amount outstanding in the bill payable account at that time was five hundred thousand. In addition to that there was surplus available of some hundred and sixty thousand.

Aside from those facts, another very important fact from the cases is the fact that these loans and stock ownership are not pro rata. As a matter of fact, I think it is safe to say on the stipulated facts that over 50 per cent of these interest payments on the taxable years involved herein which are disallowed were interest payments to people who are

not even stockholders of the Wilbur Security Company, the [6] petitioner herein.

As I say, the question of course becomes whether you look back to 1915, but certainly we don't think that that is what you do. We think we have got some pretty good case law that we will point out in brief and you look at the issues, what they were at that time. The paid-in capital and the fair-market value of the assets, if that is done, as I think should be, there is no question about the inadequacy of the capital of this company.

I would just conclude by saying that when your Honor hears the evidence we feel that you will hold as we think you should hold that these amounts were absolutely and without a question loans and that the disallowance of the interest on the thin capitalization theory or any other theory by the government is erroneous.

The Court: Thank you.

Mr. Constable.

Mr. Constable: Your Honor, that was a very good statement of the issues. I liked Mr. Butler's reference particularly to the issue on the depreciation.

Can we stipulate that you are conceding that, Mr. Butler?

Mr. Butler: I think the issue involves \$30 and we will agree that there is no contest as far as that is concerned. We have abandoned our assignment of error in the petition. [7]

Opening Statement On Behalf of the Respondent
by Mr. Constable:

Your Honor, I think by now you have a good idea of the primary issue involved. There is much more to the facts than Mr. Butler has indicated. The government will show and the exhibits will show that the notes—oh, and incidentally, on those notes we have stipulated and very carefully stipulated that the notes were executed. We have not stipulated that the notes were delivered or negotiated or anything other than that they were brought into existence. They were printed forms which the president of the corporation signed as notes payable. We think that the notes themselves and the funds which they represent are part of the capitalization of this corporation and that the increments attributable to that capital should flow out of this organization as a dividend and not as interest. We will see how the board of directors of the board of trustees deals with these notes more or less as it sees fit.

And also another factor to be considered is the close family relation involved between the stockholders, the people who are stockholders, officers, and directors. There are, it is true, what you would term outsiders who are not, who have advanced, or placed funds with this organization that are in issue, who are not officers, they're not stockholders, but they happen to be people who are closely related to stockholders or officers. [8]

I think, unless your Honor would care to hear more of the detail that is contained in our stipula-

tion of facts, and perhaps some of the things that will be developed in the evidence, I will let my opening statement as to what is to come close at this point.

We do have some additional matters. I have some objections in the deposition when it is offered and I have some objections within the stipulation of facts, those matters pertaining to relevancy of exhibits primarily.

Mr. Butler: I would then offer at this time as a part of the record in this case a 12-page stipulation of facts with Exhibits 1 to 43-QQ attached thereto, which is executed on behalf of—

The Clerk: Joint exhibits?

Mr. Butler: Yes.

We would like to withdraw for the purposes of photostating, 14-N, Exhibit 29-EE to Exhibit 36-JJ, which are the notes and I believe Mr. Constable doesn't have a copy of those either, so—

Mr. Constable: Your Honor, I will make a request to withdraw—I would rather wait until the close of the hearing because there may be some additional exhibits that I would wish to withdraw.

Now, the stipulation, that's been offered for filing.

The Court: I haven't accepted it yet. I want to [9] understand a little further concerning your position as to your objections.

Mr. Constable: I have no objection with the exception of certain exhibits and I believe one paragraph which does not have an exhibit.

The Court: The stipulation of facts together

with the exhibits attached thereto is received subject to respondent's objection.

The parties may upon request of the clerk and giving to him of a receipt, withdraw any original documents and substitute photostats therefor.

Mr. Butler: Thank you, your Honor.

Mr. Constable: Does the Court wish to hear my objections at this point?

The Court: Are these to items in the stipulation of facts?

Mr. Constable: To items in the stipulation of facts, that is correct, your Honor.

The Court: The Court, I don't believe that the Court should rule at this time on any of those objections. I would suggest that it is appropriate that you submit your objections along with your brief. Would that be agreeable?

Mr. Constable: I think on these particular exhibits that if the Court takes them under those conditions I doubt that I would have additional evidence to counteract them in [10] the event they are received or given great weight.

The Court: In other words, my holding a ruling in abeyance will not interfere with your conduct of the trial?

Mr. Constable: That is correct. That is because, your Honor, they are so remote and irrelevant that it will make very little difference in the proceeding.

Mr. Butler: I won't embarrass the respondent by asking him to make his objections in open court. I think he would prefer to do that.

(Petitioner-Respondent Exhibits Nos. 1 to 43-QQ were received in evidence.)

The Court: Is petitioner ready to proceed?

Mr. Butler: I would also like to request at this time the original deposition in Docket No. 68408 which was taken on behalf and at the instance of the petitioner in Seattle, Washington, on November 8, 1957, the testimony of Grace Lewis Phillips and Mr. John McPhearson, and I would like to offer the deposition under the rules as evidence and part of the record in this proceeding.

Mr. Constable: Your Honor, I have some objections here to the deposition.

The Court: Are they noted in the record?

Mr. Constable: They are all noted with the exception of an objection which I will make for the record at this time.

Your Honor, I think I will withdraw that remark. No [11] objection was noted and, as I understand, under the rules we waive all objections except materiality and relevancy, therefore I will withdraw that remark.

However, I will object to, in the deposition of Grace Lewis Phillips, page 7, line 11, the question beginning, "Now would you, if you had been requested, have subordinated this amount in the loan account to other creditors?"

I also object to the deposition of John McPhearson, page 9, the question beginning at line 15, "If the Company had gone defunct for some reason would your amount in the special account have taken precedence over the stock account". And

in the same deposition at page 27—correction—I will withdraw my objection to page 27, but further object in the same deposition, page 43, to the question beginning at line 9, and to the line of questioning following with regard to the \$2,300 evaluation. That objection is not noted, but I make my objection on the grounds of its relevancy. And in the same deposition, at page 40—

The Court: You said and in the line of questioning following. Is that sufficiently clear on the record so I know where your objection goes?

Mr. Constable: I think it is and it is the same question that will come up in perhaps five or six exhibits in the stipulation of facts.

The Court: Thank you. [12]

Mr. Constable: In the same deposition at page 45, question on line 1, "What in your opinion would be the fair-market value of these properties?"

And in the same deposition, page 46, the question beginning at line 13—correction—line 12, the question beginning, "Now, as a noteholder in the Wilbur Security," et cetera.

Those are all the objections I have to the deposition, your Honor.

The Court: The deposition will be received subject to the objections of respondent.

Mr. Butler: Would your Honor prefer that I argue my evidence now or at the time of the briefs?

The Court: I suppose it would keep the record clearer to argue it now.

Mr. Butler: I can briefly note, then, if I may.

The Court: If we are going into this the Court may be in a position to go ahead and rule.

Mr. Butler: That is why we made the opening statement first.

I can just note them, your Honor, and if you want to reserve your ruling there is certainly nothing wrong with that, it won't restrict us in any way I am sure.

The first objection that Mr. Constable noted was on page 7 of the deposition. The question, "Now, would you, if [13] you had been requested, have subordinated the amount in the loan payable account to other creditors?" The question was objected to as calling for a possible state of minor conclusion of the witness. The witness Grace Lewis Phillips is a noteholder in the Wilbur Security Company and certainly as such is entitled to testify as to her intent, since intent is really the crux of this whole matter. That is a question she can answer, it is her own state of mind, but that is the only thing that is important, what she would have done.

The Court: Mr. Constable.

Mr. Constable: If your Honor please, you will note that the objection is also on the ground that it is a hypothetical question. The question reads, "Now, would you, if you had been requested, have subordinated this account in the loan account of other creditors?" There is nothing to indicate that this witness had ever been requested to perform this particular act. Mr. Butler's question was predicated on facts that were purely hypothetical.

Mr. Butler: I would submit, your Honor, that you can certainly ask a hypothetical question of a party who is clearly in this thing as Grace Lewis Phillips. She had her own indications as to how she felt the account was to be treated and she so testified for what it is worth.

The Court: The objection is overruled.

Mr. Butler: The next objection was in the deposition [14] of Mr. J. McPhearson, which was on page 9 of his testimony, the question reading, "If the company had gone defunct for some reason would your amount in the special account have taken precedence over the stock amount?" Again, your Honor, the objection was that it called for a conclusion.

The Court: I don't see the question on page 9.

Mr. Butler: Line 15.

Mr. Constable: This deposition has moved, the second witness is in the back of the deposition, J. McPhearson. If you will note at the bottom of the deposition there are two witnesses, a Phillips and a McPhearson.

Mr. Butler: Yes, I am sorry, I didn't clear that up, your Honor.

Mr. Constable: The numbers begin at one for each witness.

Mr. Butler: The objection to that was that it called for a conclusion and the respondent objected. Again, Mr. McPhearson during the years involved herein, I think I am correct in saying that he was both a noteholder and a stockholder in the Wilbur Security Company, and certainly his intent with

regard to how he felt, what his thought was, on this amount is important and he is simply being asked in his own opinion or whether he thought or in his own intent if the corporation for some reason couldn't pay off everything whether he would, because of this noteholding, come in ahead [15] of the stockholders, of which he was one.

Mr. Constable: Your Honor, the question reads, "If the company had gone defunct." Now, I take it, the word "Defunct" is tantamount to bankruptcy, "If the corporation had gone defunct for some reason would your amount in the special account have taken precedence over the stock account?" That is strictly a question for the courts to determine who would take the precedence over the remaining assets of this corporation if it became insolvent. Mr. McPhearson was not competent to express an opinion on that matter of law.

Mr. Butler: Mr. McPhearson was competent to express an opinion on how he felt, since the intent is the crux of this matter.

The Court: The objection is sustained.

Did this discussion cover the second question?

Mr. Butler: That of subordination, your Honor.

The Court: I note here two questions and two objections. Now, they're right together. I think it is basically the same question and the same objection.

Mr. Constable: There was an objection, your Honor, that I intended to make on page 6 but I abandoned it.

The Court: I am speaking of the question, "Would the amount outstanding in the special ac-

count have been prior to the stock ownership if the company had followed up," then there was an objection. [16]

Mr. Constable: That is correct, your Honor.

The Court: Then another question, "Would you in effect be ahead of the stock by virtue of this special account?" Then another objection. As I understand, the record here it is unclear.

Mr. Butler: I will certainly go along with that first objection above because the answer was, "No." So I am in full accord with that. I think it is safe to say the two go hand in hand.

Is that right, Mr. Constable?

The Court: The objection is sustained.

Mr. Butler: The next objection noted is for a line of questioning at page 3, and here on redirect examination we developed, or tried to develop, the fact that there had been, this stock in the Wilbur Security Company had been evaluated for state tax purposes in an agreement between the government and the executrix of one of the parties. Again I think that is evidence that is certainly relevant. In the estate of Herbert Miller, which was a Ninth Circuit case, the valuation by the government of stock in the taxpayer company was given great weight by the Ninth Circuit Court. I certainly think that what the government thought the stock was worth at that particular point is indeed material and relevant to this controversy.

Mr. Constable: Your Honor, this particular objection [17] now is the one which will arise in the

stipulation of fact again. It appears obvious from the question that what is involved is that the witness' wife died and they had a problem of evaluating the stock of the corporation that is here involved. Mr. Butler has made that or is attempting to make the market value of that stock an issue in this case. Assuming that is material, assuming that it is relevant to this proceeding to determine the market value of the stock, I submit that an offer in settlement which is accepted should not be relevant in a proceeding of this sort to determine here what the value of that stock is. How do we know what the parties did when they negotiated the settlement of the \$2,300. There may have been other considerations, other factors, which would tend to have caused a \$2,300 evaluation to be placed on the stock for purposes of settlement in that particular proceeding. We are here litigating the value of this stock. Mr. Butler is attempting to prove its value by what other parties did in another controversy at a time during which we have no knowledge of the negotiations leading up to the eventual settlement at \$2,300.

Mr. Butler: Well, I would certainly say that true, the parties got together and agreed, there may have been other things, but the government said at that time, which is a material time herein, that the stock was worth \$2,300 a share and we certainly know that the revenue agents in the field are [18] not giving the taxpayers' money away. As I repeat, the valuation of stock in a thin incorporation case on or about the time of the interest disallowance

was a material factor in the Ninth Circuit opinion in the Herbut Miller case.

The Court: You will have to give the Court an opportunity to read this. It will take a minute or so.

Is this particular objection noted on the record?

Mr. Constable: Your Honor, the objection goes on the grounds of relevancy, which I understand according to the court's rules can be raised without being noted at the time of hearing. There is one interesting aspect.

The Court: The thing I am trying to get to here is the question that was finally objected to in the record didn't seem to involve the question of the settlement but the question as to thin market value in the witness' opinion as to certain farm land, is that right?

Mr. Butler: Again I think I have confused you, I am sorry, your Honor.

The Court: I don't know who has, but somebody has.

Mr. Butler: This is the objection at page 43. It is the line of questioning beginning, "Did you have any controversy with regard to the valuation of the stock in the Wilbur Security Company with the Internal Revenue Service at the time your wife died?" I think Mr. Constable said he objected to that line of questioning and I take it that that goes down to [19] the answer at the bottom of page 43.

The Court: Is that correct?

Mr. Constable: That is correct.

The Court: The objection is overruled.

Mr. Butler: I guess the last objection, your

Honor, is with regard to the line of questioning on Mr. McPhearson's opinion as to the fair market value of the farm properties held by Wilbur Security Company during the taxable years '53, '54 and '55. Now, Mr. McPhearson testified that he was familiar with the real estate values, the record shows he's been in the banking business and in and around Wilbur since 1903, he's had a great deal of experience with this, he was simply asked in his opinion the fair market value. He certainly gave it. He said in his opinion it would be worth over a million dollars. We have other testimony on the fair market value of this testimony. I am not——

Mr. Constable: Mr. Butler said he has other testimony. It is this particular testimony of Mr. John McPhearson that we are concerned about.

Mr. Butler: I didn't mean it that way, Mr. Constable. I meant that——

Mr. Constable: Yes.

The objection, your Honor, is based on the grounds that Mr. John McPhearson, the witness, has not been qualified as an expert to testify as to market value of this property [20] and it is based on the grounds that his statement is an opinion.

Mr. Butler: The objection in the record is to the fact that he's asked this question without identifying the farms, their locations, their nature, their acreage, and related matters, he was then asked, "I am speaking about the farms owned during the years '53, '54 and '55, owned by the Wilbur Security Company." Now, is this a new objection? I am sorry, I am confused now.

Mr. Constable: The objection is made on page 44 and is not the one in issue. I will withdraw that objection. The objection referred to is the one on the top of page 45.

It is true, your Honor, that there the reason for the objection is not noted in the record. I am in error, your Honor. Technically the objection goes to the competency of Mr. John McPhearson and we have not objected to that. I will withdraw it and save the Court a ruling.

The Court: Does that dispose of all the objections?

Mr. Butler: I think it does, your Honor. It did of the ones I kept track of.

Mr. Constable: Was there not an objection on page 46?

Mr. Butler: Of Mr. McPhearson's testimony?

Mr. Constable: Yes.

Mr. Butler: Yes, I am sorry.

The question reads, "As a noteholder in the Wilbur [21] Security Company, when I say noteholder I have in mind either the stockholder account, during these years the special account, or the note account, during the depression years if you had taken your money out of the Wilbur Security Company could you have loaned that money to somebody else at the same interest rate?" The objection is calling for a conclusion and not for a fact. I believe Mr. McPhearson, who, as I say, had been in the banking business since 1903, could render an opinion, a conclusion on that question.

Mr. Constable: Well, your Honor, I will stand on the objection. Mr. John McPhearson was asked whether or not he could have loaned the money to someone else at the same interest rate. I assume the question is the same as asking Mr. John McPhearson what the interest rate was in that year, in his opinion what would be the going market rate.

Mr. Butler: Well, just to clear it up, we signify that this is during the depression years and it wasn't at all hard to loan money during those years. The next question I think ties it in, "Could you have loaned it with the same security behind the loan as you had at the Wilbur Security Company?" And he said, "I don't think so, I don't think so, we had a lot of assets in the company," which I think is of some materiality and relevancy to this proceeding.

The Court: The objection is overruled.

Mr. Constable: I think that is all there are, then, [22] your Honor, in the deposition.

Mr. Butler: Yes, that is correct.

The Court: Then the deposition is received subject to the rulings that the Court has made with regard to various objections.

[See page 125.]

You may call your witness.

Mr. Butler: I would now call Mr. J. McPhearson to the stand, please.

Whereupon,

JOHN K. McPHEARSON

called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name, please.

The Witness: My name is John K. McPhearson.

Direct Examination

Q. (By Mr. Butler): Would you state your address? A. Wilbur, Washington.

Q. And your occupation for the record?

A. Banker.

Q. Now, you are the J. K. McPhearson that is referred to in these various exhibits that we have stipulated. Would you for the purposes of the record explain your relationship with the other people involved herein, the other McPhearsons, that is, your grandfather, your father, your sisters? [23]

A. D. K. McPhearson was my grandfather. J. McPhearson is my father. Are there any others you wish?

Q. Your mother?

A. My mother was Elizabeth McPhearson.

Q. Your sister?

A. My sister is Catherine Bernhard.

Q. Now, what is your position, Mr. McPhearson, in the Wilbur Security Company?

A. My current position is president of the Wilbur Security Company.

Q. What is your current position in the Wilbur State Bank?

(Testimony of John K. McPhearson.)

A. I am also president of the Wilbur State Bank.

Q. During the years 1953, '54, and '55, what was your position in both of these organizations?

A. I was vice-president in both of the organizations.

Q. Were you on the board of directors?

A. Yes, I was also on the board of directors.

Q. During these years? A. Yes.

Q. Now, you know we are talking here about the Wilbur Security Company and the government's position with regard to these interest payments. When did you first become a stockholder in the Wilbur Security Company? A. 1939. [24]

Q. When did you first become a billholder or noteholder? A. In the early 1930's.

Q. Now, the stipulated facts show that in 1943 an account was opened called the bill payable account. My question is when were bills evidencing the amounts first issued to the best of your knowledge? A. In 1943.

Q. The notes are in evidence and I won't withdraw them and confuse the record unless you want them to refer to, but the notes were renewed as the stipulated facts show to 1948. Could you tell the Court what happened with regard to these notes from 1948 to 1951, if you recall? Were new notes issued? A. Yes.

Q. During these years? A. Well——

Q. (Interrupting) 1948 to 1951?

A. It's hard for me to remember without looking

(Testimony of John K. McPhearson.)

at the notes because in some years new notes were issued and in some years the notes were renewed.

Q. Well, the stipulated facts show that we only have notes up to '48, and that from 1951, or to '50, there is a gap and I wondered if you could testify as to whether you knew, whether you know the notes were issued then. If you can't, that is fine.

A. Yes, there were notes in evidence at that time. [25]

Q. Did you make a search for those notes?

A. Yes, I did.

Q. And you made a search for the earlier notes, too, the ones issued from '43 on? A. Yes.

Q. You heard your father's testimony that those had been destroyed by a flood, the earlier notes?

A. Yes.

Q. Did you subsequently make a search for the notes? A. Yes.

Q. Is that what you found?

A. Yes, that is what I found.

Q. I just wanted to clear that up because in the deposition there is some question. Now, with regard to the note issued in '51, which is in evidence, was that the notes from '51 to '55, were new notes issued each year? A. No, not during that time.

Q. How were these handled?

A. Well, the notes were left in the possession of the noteholder, to the best of my knowledge, and they were merely noted as being renewed at that time and on each of those years the noteholder, par-

(Testimony of John K. McPhearson.)

ticularly in my own case, I received a cash interest payment.

Q. Now, again the years '51 to '55, where were the notes kept, do you know? [26]

A. Well, the note that I held was kept in my belongings in the vault of the State Bank of Wilbur.

Q. Do you know of your own knowledge whether other papers were kept there of other individuals?

A. Yes, there were other papers kept there.

Q. What was the reason for this?

A. Well, during that period of years our safety deposit box vault in the State Bank of Wilbur wasn't large enough to supply our customers so all of the papers of the officers of the bank were withdrawn from the safety deposit boxes so they would be available for the public. We in turn then put them in the bank vault.

Q. Did you testify that you had possession of your note? A. Yes.

Q. Now, you had an amount outstanding in the so-called bill payable account from 19 — well, up through the taxable years involved herein, is that correct? A. Yes.

Q. How did you characterize that amount?

A. I characterize it as a loan to the company.

Q. Why?

A. I had a note in evidence of it.

Q. Do you know the difference between a stock and a note? A. Yes.

(Testimony of John K. McPhearson.)

Q. Would you explain what you think is the difference? [27]

A. Well, a stock is a right in the residual assets of the corporation upon dissolution and in the case of the stock here of Wilbur Security it carried with it a right for dividends and a voice in the management.

Q. Now, what was your interest in the note payable account at this time, in your opinion, I mean?

A. I held a note there stating a definite sum of money payable at a definite time. Of course the thing was in writing.

Q. Was there a time, Mr. McPhearson, when you owned an amount outstanding in the note payable account but owned no stock? A. Yes.

Q. Did you participate in any of the corporate meetings or anything when you were not a stockholder? A. I did not.

Q. Why?

A. I had no voice in the management of the company.

Q. Did you prior to the time that you became a stockholder share in any corporate profits?

A. None.

Mr. Constable: Your Honor, I will object now. These matters are all problems that are in issue. The witness is testifying that he never shared in any profits of the Wilbur Security. That is the very issue, whether or not the moneys [28] he received and reported as interest were in effect dividends or

(Testimony of John K. McPhearson.)

profits coming to him from the surplus available to Wilbur Security.

Mr. Butler: Well, I think that we are not trying to say by this line of questioning that he didn't receive interest or what he received might not be eventually termed by your Honor a dividend but at a time when he had an amount outstanding in this note payable account the corporate earnings none of which were distributed to him, and I think he can testify to that. He got interest, the stipulated facts show that, but the only thing I am showing he had no stock interest and obviously he did not share in the corporate profits.

The Court: The objection is overruled.

Q. (By Mr. Butler): Were you ever requested by the company to subordinate the amount outstanding in the bill payable account to other creditors? A. No.

Q. Did you ever withdraw any amounts from the bill payable account during any of the years involved herein or prior?

A. Would you state what years you have in mind?

Q. When did you first become a holder in the—well, from 1943, up to the present time.

Q. Yes, I withdrew in 1957.

Q. In 1957? [29] A. Yes.

Q. How much did you withdraw in 1957?

A. The entire amount.

Mr. Constable: That is immaterial. I object to it on those grounds. '57 is not the year in issue here.

(Testimony of John K. McPhearson.)

Our years run up through 1953, through 1955. I submit that anything that takes place after 1955 is not material to this issue, to these years.

Mr. Butler: I think subsequent events tend to show the nature of this account, your Honor, and I think it would certainly be our position that it is material. He withdrew all his amounts in 1957. He is no longer a loaner or a lender to the corporation. He took it all out. I think there is some evidence that he is still a stockholder. I mean, I think it certainly isn't decisive. I don't mean that, but I think it has some materiality.

The Court: The objection is overruled.

Q. (By Mr. Butler): Now, only with regard to your particular notes that you had from '43, through the taxable years. You have testified that there were times when you didn't get a new note. Now, how were the renewals handled?

A. We were just notified that our note had been—I shouldn't say notified, we were requested as noteholders to renew the note and if, in my particular case, I agreed. [30]

Mr. Constable: I will object, your Honor, to that question on the grounds that first of all, I don't know who "we" is that he is referring to or I don't know who is requesting him. I think I have a best evidence objection here. I would like to see this request if there was one made. I can't tell from the question whether the request was oral or written.

Mr. Butler: The best evidence rule only applies in the case of where you are trying to take a docu-

(Testimony of John K. McPhearson.)

ment and show that that document says what it purports to say. As I see it, the man was requested by the company to renew, he so testified. He can certainly testify, he was a noteholder, he went through this and he can testify what happened and I only ask him as to his note. There is no best evidence, as I see there is no document in here that we are trying to prove.

The Court: The objection is overruled.

I would suggest that counsel will clear up any ambiguity in the answer as to the "we" problems as to who he was talking about.

Mr. Butler: Yes.

Q. (By Mr. Butler): You said we were requested, or you said somebody requested you. Would you explain that to the Court just what happened?

A. The board of directors would request us or their [31] representative.

Q. Now, you testified that when you received—became a stockholder in the company—what year was that?

A. I became a stockholder in 1939.

Q. Did you at that time also get \$800 a share of the whole special account at that time? Did an amount from the special account also go over to your name by virtue of your becoming a stockholder?

A. I deposited some money in the company or lent them, I should say, in 1939.

Q. Did you know as an officer or stockholder or

(Testimony of John K. McPhearson.)

director of the company that the by-laws provided for a transfer of \$800 a share, \$800 out of the original two hundred thousand with each share of stock?

A. I didn't know it until the Internal Revenue Department pointed it out to us.

Q. When was that?

A. When they made the first examination, I believe sometime in 1956.

Q. Prior to that was this provision adhered to?

A. Not on my behalf.

Q. Now, the stipulated facts show that over the period of years when you yourself had an amount outstanding in the note payable account the notes provided, the minutes provided variable interest rate, is that correct? Some years it was three [32] per cent, some years four or five, is that correct?

A. Yes.

Q. How would that come about, would you explain that?

A. Well, interest is the price of money and I would say that was the amount that was agreed upon by the lenders and the borrowers to secure these funds for the company.

Q. Are you as a banker familiar with interest rates?

A. Generally so.

Q. And how long have you been in the banking business?

A. Since 1939.

Q. Were the interest rates provided for by the Wilbur Security Company and payable on the note

(Testimony of John K. McPhearson.)

on the bill payable account in your opinion excessive? A. They were not.

Mr. Butler: Now I'd like to withdraw for the purposes of examination Exhibit 27-BB, I am sorry.

Q. (By Mr. Butler): I show you, Mr. McPhearson, Exhibit 28-BB, and would you briefly describe what it is. Can you identify it?

A. Yes, I can identify it.

Q. What is it?

A. It is a letter addressed to myself as president, from the National Bank of Commerce.

Q. The date of the letter?

A. December 11, 1956. [33]

Q. Just in your own words.

Mr. Butler: I am not characterizing, George, I just want his Honor to know.

Q. (By Mr. Butler): What does it provide in substance?

A. It provides that on behalf of the Wilbur Security Company I made an application of a loan from the National Bank of Commerce from Seattle in the amount of five hundred fifty thousand for the period of one year.

Q. And what was the interest?

A. They gave an affirmative answer to this. They said they would loan this amount and at an interest rate of four and a half per cent.

Q. Did the bank take any action as a result of this letter, I mean the Security Company take any action as a result of this letter?

(Testimony of John K. McPhearson.)

A. Yes, they did.

Q. What was the action taken?

A. They used it to determine the interest rate on the amount of money they borrowed and subsequently the interest rate to our present noteholders was reduced.

Q. Did you say the interest was reduced? Would you explain that, please, for the purposes of the record?

A. As I recall, in 1956, the notes that the Wilbur Security Company had outstanding bore six per cent. Following [34] that time we reduced the—when we renewed them on the current first of the year, we reduced that to five per cent. We gave a slight bit more interest because we felt that we could borrow for a longer time from our present noteholders than we could from the bank.

Q. Now, Mr. McPhearson, you have testified, I am not leading you, I just wanted to reiterate here for the purposes of saving time, you were a director, a stockholder, and up until recent times, a noteholder in Wilbur Security Company. Did you attend during the years '52, '3, '4, and '5, the meetings of that company?

A. Yes.

Q. Were any of the non-stockholders who also had amounts outstanding in the note payable account present at those meetings?

A. They were not.

Q. Did they have anything to say about the management of the business?

A. They did not.

(Testimony of John K. McPhearson.)

Q. Did they share in the profits other than your interest payment? A. No.

Q. Now, again on your own account, you have been a noteholder, has your stock fluctuated over the years in value, in your opinion? [35]

A. In my opinion it has.

Q. Did that in any way affect your note payable holdings? A. No.

Q. Who were the stockholders in the Wilbur State Bank in 1953, 1954, and '55?

A. The stockholders were E. H. Olswalt, Godfrey Thompson, and J. McPhearson, and Mrs. Grace Phillips, and myself, John K. McPhearson.

Q. Were those individuals also the officers of the Wilbur State Bank during these years? Who were the officers of the Wilbur State Bank?

A. The officers of the Wilbur State Bank during these years were E. H. Olswalt, Godfrey Thompson, J. McPhearson.

Q. Their position, I mean I want you to say that.

A. E. H. Olswalt was assistant cashier at the bank. Godfrey Thompson was the cashier, and J. McPhearson was the president, and I, John K. McPhearson, was the vice-president. There were also other officers however at the bank.

Q. Well, who were the officers of the taxpayer corporation during the years '53, '54, and '55? We neglected to stipulate that.

A. The officers were G. Thompson was secre-

(Testimony of John K. McPhearson.)

tary, and I, John K. McPhearson, was vice-president, and J. McPhearson was president.

Q. Who were the directors, Mr. McPhearson, during the [36] years '53, '54, and '55?

A. The directors were those listed plus E. H. Olswalt and Mrs. Grace Phillips, if my memory serves me right.

Q. How were the interest payments on the note payable, on your note payable account, the interest paid in '53, '4, and '5, how was that handled, do you know?

A. Yes.

Q. Would you explain that?

A. It was deposited to my checking account in the State Bank of Wilbur.

Q. In the State Bank of Wilbur? A. Yes.

Q. Of the people who appear in the Wilbur Security Company in the exhibits that we have attached and you are familiar, I am sure, with them, how many are now alive of the original founders of the Wilbur Security Company?

A. Just two.

Q. And who are they?

A. They would be J. McPhearson, my father, and E. H. Olswalt.

Q. Now, in the stipulated facts it shows that in, I believe, 1952, or '51, the notes were issued providing for six per cent—no, five per cent and then in November of '52 the stipulated minutes show that that rate was changed. Now, were you present at the meeting when it was decided to change the [37] interest?

A. Yes.

(Testimony of John K. McPhearson.)

Q. What transpired, would you tell the Court?

A. Well, it was felt by the——

Mr. Constable (interrupting): Objection, your Honor. The minutes will show what transpired at the meeting.

Mr. Butler: I think the minutes don't show any of the discussions that went on and since he was there and also a member of the company, I think he can testify as to what transpired. There were some decisions made that just don't appear in the minutes. Obviously it isn't customary that the minutes are particularly voluminous on things of this nature.

The Court: The minutes have been stipulated?

Mr. Butler: That is correct, your Honor, and the notes show that there has been a change of interest made.

The Court: The objection is overruled.

Q. (By Mr. Butler): Would you answer that, Mr. McPhearson?

A. The meat of the discussion at that time, as my memory serves me, the interest rate seemed low to the directors of the Wilbur Security Company and they felt that they didn't want any of those noteholders to withdraw their funds and that was graded as an added incentive for them to renew those notes when they became due at the end of that year.

Q. Who made the endorsement on the back of the notes [38] when the interest was paid or who

(Testimony of John K. McPhearson.)

made the endorsement on your note when the interest was paid?

A. The note would be in my possession and if I made any I made them on my particular note.

Q. Is that customary in the banking business?

A. Yes, the noteholder would necessarily have to make his own endorsements because he has possession of the note.

Mr. Butler: I have no further questions.

The Court: Off the record.

(Discussion off the record.)

The Court: Back on the record.

The Court will stand in recess for five minutes.

(Short recess.)

The Court: The Court will come to order, please.

Cross Examination

Q. (By Mr. Constable): Will you just state again, Mr. McPhearson, what your full name is?

A. John K. McPhearson.

Q. J. K.? A. Yes, J. K.

Q. You were president of Wilbur Security Corporation what years?

A. I became president in 1956.

Q. You became president? [39]

A. I was vice-president; I became vice-president in 1940.

Q. 1940? A. Yes.

Q. During that time you were working with the affairs of Wilbur Security, were you not?

(Testimony of John K. McPhearson.)

A. Yes, except for the war years in which I was in the navy. I was absent at that time.

Q. At the same time were you working for the State Bank of Wilbur? A. Yes.

Q. You had two jobs? A. Yes.

Q. What did you do as far as Wilbur Security is concerned, what were your duties during 1940 through 1955?

A. Well, in the—that is hard to answer because they changed as those years went along.

Q. Did you spend ten, twenty per cent of your time with Wilbur Security?

A. I would say as far as day-to-day business was concerned, approximately ten per cent of my time.

Q. Did anyone spend more than ten per cent of their time with Wilbur Security?

A. Yes, I would say Mr. Thompson.

Q. I see. You, being a vice-president, you were quite familiar with its affairs, were you not? [40]

A. Yes, as familiar as you can be and only do part of the work.

Q. Well, Mr. Thompson was the only person you would say was really more familiar than yourself?

A. Yes, and my father probably was more familiar than I was. Especially in the earlier years.

Q. Did you have occasion to handle the books of account of Wilbur Security?

A. No; Mr. Thompson handled all those.

Q. You recall that you testified as to a note payable account. Do you recall your testimony to Mr. Butler in connection with a note payable account?

(Testimony of John K. McPhearson.)

A. No, I don't.

Q. Well, how, do you know in what account on the books the amounts evidenced by your notes were carried?

A. They were carried in the notes payable—what year are you speaking of now?

Q. Let's take the year 1953.

A. They were carried as notes payable.

Q. What was the name of the account?

A. Notes payable.

Q. The notes payable account?

A. Let's see. The reason it is a little confusing we changed the nomenclature of that a little later. Bills payable, I think they called it. [41]

Q. I see. When did you change it from notes payable to bills payable?

A. We redid the books in 1956, and I think we changed the nomenclature there to a, let's say a more modern nomenclature.

Q. I see. The designation of the account, then, was really rather unimportant?

A. Yes, I would say so.

Q. It didn't mean anything?

A. Well, it served as identification.

Q. When you were a noteholder and the end of the year came along, say, the end of the year 1953, what was the procedure, now, for renewing your note?

A. In that particular year, if I remember right, I as a noteholder would usually be asked by Mr. Thompson, who represented the company, and of

(Testimony of John K. McPhearson.)

course I was also present at the board of directors' meeting, asking if we would, if I would, particularly in my case, renew my note at the end of the year.

Q. There was never any doubt but what you would?

A. Well, there wasn't any doubt in my mind.

Q. Did anyone ever tell you that they had any doubts about renewing their note?

A. In what year?

Q. 1953, '4 or '5.

A. No, they didn't tell me. [42]

Q. It was more or less automatic?

A. Well, I am a little at a loss at what you call automatic.

Q. You heard your father's testimony, didn't you, Mr. McPhearson? A. Yes.

Q. I think he testified to the effect that the notes were renewed rather automatically. Would you consider that a fair statement of the facts?

A. I would say that we assumed that they would be.

Q. Did you take your note with you to that meeting?

Mr. Butler: Would counsel clarify the question to what meeting.

Q. (By Mr. Constable): To the meeting concerning the 1953 renewal. A. No.

Q. Were any of the notes present at that time?

A. You must keep in mind that the meeting was held at the State Bank of Wilbur and the office

(Testimony of John K. McPhearson.)

wasn't 20 feet from the vault in which I kept my note. There was little purpose in taking it 20 feet out to the desk and holding it and taking it back.

Q. When you kept it in the vault the other notes were kept with it, were they not?

A. Not in the year 1953. I had the note in my possession [43] in my own belongings.

Q. You had a section of the box for yourself?

A. Well, it is a little embarrassing. I had a box, a cardboard box, to be exact.

Q. When you renewed the note did you take it to Mr. Thompson?

A. Not in the year 1953, I didn't. I retained possession of it.

Q. All they did was simply pay you interest on it?

A. They did.

Q. Was that a check?

A. No, it was merely a debit slip was put on the Wilbur Security Company account and the amount representing that debit slip or my interest on the note was then put on my checking account.

Q. I see. It was a book entry more or less?

A. Yes, but I did receive the money on my checking account.

Q. You spoke about a request that was made in connection with renewal of the notes. Was that a written request?

A. No.

Q. It was verbal?

A. Yes.

Q. To your knowledge had there ever been—

A. (Interrupting) You are speaking of the request to me?

(Testimony of John K. McPhearson.)

Q. Yes. [44] A. Yes.

Q. To your knowledge had there ever been a written request made in any year?

A. I couldn't testify to that.

Q. Had there ever been a written request made to you? A. No.

Q. As the vice-president of Wilbur Security you didn't know in any of the years from 1940 through 1955 whether or not a written request had been made in the case of the renewal of any notes?

A. I wouldn't know of it, no.

Q. As a matter of fact, Mr. McPherson, the requests are customarily made verbally at these meetings, are they not? A. Yes.

Q. Is there usually much negotiating taking place during the renewal of the notes at the meetings?

A. I am afraid I don't understand what you mean.

Q. Does Wilbur Security bargain with the note-holders? A. You mean on a bidding basis?

Q. Are there any discussions, negotiations leading up to the renewal of the note?

A. Not any more than would be between a customer and a banker, for instance.

Q. What type of negotiations take place, are there usually arguments? [45] A. No.

Q. Have you ever made any loans to anyone other than Wilbur Security for large, unsecured amounts of money? A. Yes.

Q. To whom were they made?

(Testimony of John K. McPhearson.)

A. In what year? I have a number of them outstanding.

Q. In the year 1952.

Q. Yes, I had a note out to a firm called O'Brien Brothers that is my own personal money. I think the amount at that time was in the approximation of \$30,000.

Q. Is this customary in the conduct of your affairs that you loan money on a promissory note without any security?

A. Depends on the man's financial statement.

Q. Does it depend on how well you know the man to whom you are loaning the money?

A. That would be an important element.

Q. It would depend to a great extent on your relations with him, would it not?

A. It always does.

Q. Do you know who the officers of Wilbur Security were from 1940 through 1952?

A. Let's see, 1940. Well, if you had stated from '41 through that time I could remember.

Q. All right, from '41 through '52?

A. It would have been J. McPhearson was president, I, [46] J. K. McPhearson, was vice-president, and Godfrey Thompson was the secretary.

Q. And do you know who the directors or trustees of Wilbur Security were for the period of '41 through '52?

A. I am relying entirely on memory. I think the stipulations would bear that out.

(Testimony of John K. McPhearson.)

Q. I would like to know what your memory is on that point.

A. Yes, if my memory is right, the board of directors consisted of Mrs. Grace Phillips, who was known at that time as Mrs. Grace Fisk, and E. H. Olswalt, and Godfrey Thompson, and myself, J. K. McPhearson, and J. McPhearson. Or did I name him before, I forgot, J. McPhearson.

Q. What year did your mother pass away?

A. 1953.

Q. At the time that she died was she a noteholder? A. Yes.

Q. Do you recall during the period following her death where you located her note?

A. It was in the estate papers of that, of that estate, and I was the executor.

Q. Where was the note when you found it?

A. It was in the possession of my father with his other papers.

Mr. Butler: Could counsel clarify that? I don't [47] think the witness understands. Do you mean, counsel, where it was when they went to look for it, is that what you mean?

Mr. Constable: I asked Mr. McPhearson where he had found the note. As I understand, he was executor and he said it was with his father.

Q. (By Mr. Constable): Referring to Exhibit 28-BB, had Wilbur Security ever requested a loan from anyone other than the Farnsworth and McPhearson family similar to that request shown on 28-BB?

(Testimony of John K. McPhearson.)

A. Would you state that again, please?

Q. Well, you testified that this was a, this letter consisted of a loan to be made by the National Bank of Commerce to Wilbur Security Company, did you not?

A. Yes.

Q. And Wilbur Security Company made that request, did they not?

A. Yes. I made it on behalf of Wilbur Security Company.

Q. Had you ever, prior to 1956, made a similar request on behalf of Wilbur Security Company to other than the Farnsworth or McPhearson family?

A. That is very confusing because there were other noteholders other than the Farnsworth and McPhearson families.

Q. Did you ever make a request to a banking organization?

A. I did not, but one was made and is in the minutes.

Q. Did the Wilbur Security Company ever inquire whether [48] or not they could borrow money cheaper than they were borrowing it from their present noteholders, say, during the year 1953?

A. I don't believe they did, no.

Redirect Examination

Q. (By Mr. Butler): Is borrowing money cheaper the thing you look to when you are getting a loan?

A. No, sir.

Q. What are the other considerations?

(Testimony of John K. McPhearson.)

A. It is hard for me to say, I am usually on the other side of the table. I am theorizing in my case as to how I would feel in loaning the money and then, on the other hand, as the borrower and representative of Wilbur Security Company. I would say that the prospect of renewal is important.

Q. Did you testify that you had independent knowledge of a prior loan that was, that you tried to get a prior loan?

A. I read in the minutes at one time that they had tried to get a loan from, I think then Fidelity.

Q. You can't testify, then, from your own knowledge about that loan?

A. I can only testify as to what I saw in the minutes.

Mr. Butler: I withdraw the question then.

Q. (By Mr. Butler): Mr. Constable asked you about Wilbur Security and how [49] much of your time was spent. Was there, in fact, a great deal to do with regard to the business of Wilbur Security? A. No.

Q. Now, you testified about the nomenclature of this account and I just want to clear the record up. Did you say that the account was originally known as the bills payable account?

A. In what year?

Q. From 1943 to 1956. A. Yes.

Q. And then it was changed? A. Yes.

(Testimony of John K. McPhearson.)

Q. What was it changed to?

A. Notes payable.

Q. Would you tell the Court just a little bit—first of all, how big is Wilbur?

A. There is about 1,100 people there.

Q. The record will show that. Do you carry on business, the banking business, similar to the way, exactly the way it is done in the bigger cities?

A. No, it on a more personal basis.

Q. Do you know most of the people you do business with? A. Yes.

Q. Mr. Constable asked you if there were any great arguments that took place with regard to bargaining with renewal [50] of these notes and I ask you do you have any great arguments with anybody in the banking business? A. No.

Q. Now, I just wanted to clear one other thing up. You said, and I wasn't sure you understood, Mr. Constable asked you where you found your mother's note, and what was your answer again?

A. I found it in papers belonging to my father.

Q. Was that when you were looking for it? What I am trying to clear up is you were executor of the estate? A. Yes.

Q. And you gathered the assets? A. Yes.

Q. Where did you find the note?

A. My father brought out all the papers belonging to the family and we found it in that portfolio.

(Testimony of John K. McPhearson.)

I might point out that that was just one of many notes.

Mr. Butler: I have no further questions.

Mr. Constable: I have just one matter, your Honor.

Recross Examination

Q. (By Mr. Constable): You testified, Mr. McPhearson, that regarding this procedure upon renewing of the notes that we were requested. I take it you were referring to the noteholders, isn't that correct? [51] A. Yes.

Q. Now, you knew, of course, that all the other noteholders, that a similar request was made to all the other noteholders, did you not?

A. No, I couldn't testify to that unless I made the request myself and it would depend then on what year you are referring to.

Q. In what year did you make the requests?

A. It would be from 1956 on.

Q. I see.

Mr. Constable: That is all I have.

Mr. Butler: That is all.

The Court: The witness is excused.

(Witness excused.)

Mr. Butler: I would call Mr. Campion to the stand, please.

Whereupon,

MORRILL W. CAMPION

called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

The Clerk: Take the stand. State your name and address, please.

The Witness: Morrill W. Campion. I live at 1104 East Thirty-seventh, Spokane. [52]

Direct Examination

Q. (By Mr. Butler): What is your occupation?

A. I am an appraiser.

Q. Would you give the Court the benefit of your experience, reiterating your experience in the appraising business?

A. Well, I graduated from the University of Minnesota, the College of Agriculture, with a degree as a Bachelor of Science in agriculture in 1926. I spent a few years in the livestock industry and in 1933 I became employed by the Federal Land Bank of St. Paul as an appraiser. I appraised for the Land Bank in 1937, at which time I became employed by the Equitable Life Assurance Society of The United States. I appraised farms in the Midwest until 1947, at which time I was transferred to the Pacific Coast and appraised farms west of the Cascades until 19—January 1952, at which time I was transferred to Spokane and have been appraising farms in Eastern Washington and Northern Idaho and part of Oregon since that time.

(Testimony of Morrill W. Champion.)

Q. Have you done any appraisal work in and around the Wilbur, Washington, area?

A. Yes, I have.

Mr. Butler: I would request of the Court to withdraw Exhibit 27-AA, which is a list of the farms owned by the Wilbur Security Company during the years involved herein. [53]

Q. (By Mr. Butler): I show you this list, Mr. Champion, and ask you if at our request—if you have seen this property—are you familiar with that list. A. Yes, I am.

Q. And what is it, Mr. Champion?

A. It is a list of the farm holdings of the Wilbur Securities Company.

Q. Have you seen all of this property?

A. I have.

Q. And when was the last time that you looked at it? A. Last Thursday.

Q. And have you at our request formed an opinion as to the fair-market value of these properties in the years at the beginning of 1953, the end of '52, and the years '53 and '4 and '5?

Mr. Butler: I withdraw the question. I am afraid I have confused you.

Q. (By Mr. Butler): Have you at our request gone over this property with the idea of appraising it, its fair market value in 1953, '54, and '55?

A. I have.

Q. Have you formed such an opinion?

A. I have.

(Testimony of Morrill W. Champion.)

Q. What in your opinion is a fair market value of the [54] farms during the years I mentioned?

A. My appraisal as of January 1, 1953, is \$1,610,000. The fair-market value for '54 and '55 would be just in excess of that amount.

Q. Now, just briefly would you care to comment on the basis of your opinion?

A. My appraisal was based on comparison of known sales of similar properties in the community, the income, anticipated income during that period of time, anticipated income to the landlord during that period of time.

Q. Did you check the income to the landlords during that time? A. I did.

Q. Or to the farm owners or to the farm renters, I should say?

A. Not to the renters; to the landlord.

Q. I see. Now, you are in the farm loan business, is that correct? A. That is right.

Q. And you, on the basis—what exactly is your job after you have appraised a farm?

A. I appraise a farm for loan purposes for the Equitable Life and make my recommendation and service the loans after they're made.

Q. Now, based on your appraisal of this property, would [55] you have recommended a loan in excess of \$5,000 of the Wilbur Security Company to your company?

A. Five hundred thousand?

Q. Five hundred thousand.

A. Yes, I would have.

(Testimony of Morrill W. Campion.)

Q. What would that be based on?

A. It is based on the market value of the farms, the credit risk involved, the anticipated income.

Mr. Butler: I have no further questions, your Honor.

Mr. Constable: No questions, your Honor.

The Court: The witness is excused.

(Witness excused.)

Mr. Butler: Could I beg your indulgence for just a second. I think we can save time.

The Court: Go ahead.

Mr. Butler: I would call Mr. Larry Morse to the stand, please.

Whereupon,

LAURENCE D. MORSE

called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

The Clerk: Take the stand and state your name and address for the record, please.

The Witness: My name is Laurence D. Morse. My address is 911 West Thirty-second, Spokane, Washington. [56]

Direct Examination

Q. (By Mr. Butler): You stated your name and address. Would you state your occupation?

A. Certified public accountant.

Q. How long have you been in that field?

(Testimony of Laurence D. Morse.)

A. Since 1946.

Q. During the taxable years '53, '54, and '55, were you the certified public accountant for the Wilbur Security Company? A. I was.

Q. Did you prepare the tax returns?

A. I did.

Q. When did you first take over this account, that is, by yourself?

A. In the tax season of 1953.

Q. Now, would you explain how that came about, if you would?

A. My partner, Mr. R. J. Wortman, had been the certified public accountant for the Wilbur Security Company for a number of years. He passed away on March 15, 1952, and I was retained by the Wilbur Security Company to prepare the tax returns.

Q. Now, have you at our request reviewed the books and records of the Wilbur Security Company with regard to the [57] entries made on the fourteen thousand item? A. I have.

Q. I see.

Mr. Butler: Might I withdraw Exhibit 150 (a)?

Q. (By Mr. Butler): I show you Exhibit 150 (a), which are the stipulated minutes of the Wilbur Security Company. I call your attention to the fact that the bills payable in the estate of Sarah A. Farnsworth was reduced in the amount of \$14,000. Have you checked the books to ascertain how that transaction was handled on the books and records of the Wilbur Security Company?

(Testimony of Laurence D. Morse.)

A. Yes, I have.

Q. Have you made a summary from those books and records for your own purposes of testifying?

A. Yes, I have.

Q. Would you tell the Court, Mr. Morse, please, what the books show, the entries in the books show concerning that \$14,000?

A. On January 1, 1953, the books show the following entry: "Sarah A. Farnsworth special account debit 17,000, credit bank 17,000."

On the same day these following two entries were reflected on the books, a debit to the bank of 1,000, a credit to the Sarah A. Farnsworth special account 1,000, a debit to the bank of 2,000, and a credit to the Sarah A. Farnsworth special [58] account of 2,000. This in effect reflects the disbursement in cash to the Sarah A. Farnsworth estate in the net amount of 14,000.

On January 4, 1954, the following entry was made in the books: A debit to the bank of 3,000, and a credit to the Sarah A. Farnsworth special account of 3,000. A debit to the bank of 5,000, and a credit to the Sarah A. Farnsworth special account 5,000.

On January 12, 1954, a debit to the bank of 6,000, and a credit to the Sarah A. Farnsworth special account of 6,000.

The effect of this is that \$14,000 was received by the Wilbur Security Company, deposited and credited to the Sarah A. Farnsworth special account.

Q. Now, was any interest credited on the books

(Testimony of Laurence D. Morse.)

of the Wilbur Security Company when that amount was repaid?

A. There was no disbursement or entry indicating that an interest payment had been made on this fourteen-thousand disbursement.

Q. Are the records of the corporation consistent with the direction in the minutes?

A. By and large they are consistent with the minutes. However, if I were Mr. Godfrey making the entry that was set forth here in the minutes of this meeting, I would have done it just a little different. [59]

Q. Good accounting principles would dictate that you follow what in making an entry such as this?

A. You follow the minutes, the minutes are controlling.

Q. Would you explain just briefly the control account that was involved?

Mr. Butler: I withdraw the question.

Q. (By Mr. Butler): We have talked briefly—I have here an account taken from the books and records of the Wilbur Security Company and ask you if you can identify it.

A. Yes, that is a general ledger page entitled “Notes Payable”.

Q. Where is this taken from?

A. That’s been taken from their most current general ledger.

Q. What years would that involve?

A. This involves the years 1956 and ’57.

Mr. Butler: I offer this in evidence at this time.

(Testimony of Laurence D. Morse.)

Mr. Constable: Objected to on the grounds of materiality.

The Court: For what purpose?

Mr. Butler: I wanted to clarify this account has been changed from bills payable to notes payable. This was made by the accountant of the company for purposes of his own. The account shows the amount outstanding in the bills payable [60] account in 1956, and 1957, and I say that these amounts have changed. Mr. McPhearson has testified that he is no longer, 1957 is no longer, a holder of any amount outstanding in the bill payable account, although it's subsequent years, I think it lends some credence to the position taken by the petitioner herein.

The Court: You quoted some examples at the time when I overruled respondent's objection on the year 1957. I have serious consideration of years not here in issue and particularly putting the books and records in.

Mr. Butler: This is everything in the note payable account up to 1956 is the subject of Joint Exhibit 14-N. This just carries on and explains these later years and also this note payable change and I would again offer it in evidence, your Honor.

The Court: The objection is overruled. It will be received.

The Clerk: Petitioner's Exhibit 44 is received in evidence.

(Petitioner's Exhibit No. 44 was received in evidence.)

(Testimony of Laurence D. Morse.)

Q. (By Mr. Butler): Exhibit 44 contains the heading "Notes Payable". Who made that change?

A. I did. [61]

Q. You changed it from bills payable to notes payable. And what was the purpose of the change?

A. When Mr. Godfrey passed away the Wilbur Security Company asked that I revise **their accounting** system somewhat and at that time I dropped the nomenclature of bills payable in that it is seldom used any more, being a very old-fashioned term, and used the terminology notes payable.

Mr. Butler: Could I withdraw Exhibit 14-N for the purpose of—I am sorry to take the Court's time, but this is something Mr. Constable wants and I want to get it in.

Q. (By Mr. Butler): I show you what has been identified and stipulated as Exhibit 14-N and ask if you are familiar with that exhibit.

A. Yes.

Q. That is the bills payable account. And I ask *if* you have you examined some of the journal entries concerning that account.

A. Yes, I have.

Q. And how was this account handled on the journal, the journal entries?

A. As an example we will take the end of the year 1943. At that time the bills payable account was debited for the amount of the note and the bank was credited indicating that the note was paid. Then on the first of the next year, which would be January 1 of 1944, the accounts bill payable was [62] credited and the bank was debited in-

(Testimony of Laurence D. Morse.)

dicating that another note was negotiated and a loan made.

Q. Did you at our request search the books with regard to the year ending 12/31/1942?

A. Yes.

Q. What was the book value of the farms owned by the Wilbur Security Company at that time?

A. It was approximately four hundred thousand.

Mr. Butler: I have no further questions.

Cross Examination

Q. (By Mr. Constable): Referring to Exhibit 14-N and to the year 1943, and the journal entries which you testified to, is the journal for that year in court?

A. Yes, sir.

Q. Referring to your testimony in connection with the check, the entries in 1943, where the notes were paid and the accounts payable account was debited and the bank was credited and on the opening of the next year that the bank was debited and the accounts payable credited, those were strictly book entries, were they not?

A. That is correct. However, the word "bank" is, I believe, well, see, in referring to this journal entry is set forth. Furthermore, I think it uses the term "cash" in there also, but it is a book entry.

Q. No cash changed hands nor were checks drawn in connection with the entries?

A. I don't believe there were. If you will refer to page 87.

(Testimony of Laurence D. Morse.)

Mr. Constable: I have no further questions, your Honor.

Mr. Butler: Is it all right if we leave Mr. Morse on the stand until we get finished with this other question here?

I would return at this time the exhibits withdrawn.

Mr. Constable: Your Honor, referring to the stipulation of facts that has been filed, due to certain difficulties in the mechanics of putting it together we found it necessary to omit paragraph 26 from the stipulation of facts. There will be no paragraph 26. Now, we had an exhibit marked for that paragraph. At the present time there is no Exhibit 23-W included in the stipulation of facts, that is a vacant exhibit number, and I would like to have this marked, this piece of paper marked as Joint Exhibit 23-W.

Would you mark it, Mr. Clerk.

Mr. Constable: Your Honor, in connection with——

The Clerk: Joint Exhibit 23-W is marked for identification.

(Petitioner-Respondent Exhibit No. 23-W was marked for identification.) [64]

Mr. Constable: Respondent offers to stipulate that the column headings on Joint Exhibit 23-W are correctly stated. Also that for the years 1915 through 1936 no interest was paid on the \$200,000 described in the special stockholders' account.

Respondent further offers to stipulate that during the years 1932 through 1936 no amounts of interest

(Testimony of Laurence D. Morse.)

were accrued on the books with regard to interest payments in connection with the special account and bills payable account.

Mr. Butler: I so stipulate, your Honor.

Mr. Constable: I will then offer Joint Exhibit 23-W.

Mr. Butler: No objection, your Honor.

The Court: It will be received.

Mr. Butler: Could I withdraw it for just a second?

The Clerk: Joint Exhibit No. 23-W is received in evidence.

(Petitioner-Respondent Exhibit No. 23-W was received in evidence.)

Redirect Examination

Q. (By Mr. Butler): I show you what has been offered in evidence as 23-W and ask you if the amounts of interest paid here from 1915 to 1936—we have stipulated that no interest has been paid on the \$200,000 in the special stockholders' account. Were there dividends paid on the \$200,000 during those years? [65]

A. No, sir, not on the special stockholders' account.

Mr. Constable: Objection, your Honor, but I think we understand——

Mr. Butler: I don't mean to characterize it as——

Mr. Constable: I will withdraw the objection.

Mr. Butler: Now, there is just one other small thing, your Honor. Mr. Constable requested that we supply him with some minutes. The minutes

(Testimony of Laurence D. Morse.)

are old minutes from the years back in the '30's and '40's. They're in a permanent minute book. Could we offer at this time the minute book and we will withdraw it and provide the Court and Mr. Constable copies of the minutes in photostat. I don't know how we will do it.

Mr. Constable: If you have found that these minutes exist I will read into the record of the four minutes I want and we will stipulate that these are the minutes I want.

The Court: I think that is definitely the thing to do.

Mr. Constable: I am now referring to the minutes of Wilbur Security Company for four meetings, first, of December 31, 1931, second of December 30, 1940, the third of December 30, 1941, and the fourth, of December 30, 1942. I will offer those, I will offer to stipulate with Mr. Butler that those may be put into evidence after we are able to make copies of them from the minute book.

Mr. Butler: Are those the directors meetings or [66] stockholders meetings?

Mr. Constable: I believe they're called either directors or trustees.

Mr. Butler: We can stipulate that if the minutes are there we will certainly give them to you.

We so stipulate, your Honor.

The Court: The Court understands that it is not definite that these minutes are in existence.

Mr. Butler: Apparently there is some question about the first one that he requested, but if we can

(Testimony of Laurence D. Morse.)

find it, if it is there we will let Mr. Constable go through the record and——

Mr. Constable: Your Honor, I——

The Court: The Court might make this suggestion that rather than receive into evidence something which is not clearly in existence that the Court would be glad to keep the record open for a period of, say, 30 days, during which you could prepare a stipulation on these minutes if they are located.

Mr. Constable: That would accommodate the respondent, your Honor.

The Clerk: As a supplemental stipulation?

The Court: Supplemental stipulation.

Would that be agreeable to both parties?

Mr. Butler: Yes, your Honor, we will be back Thursday on another case and we will try to bring them at that time. [67]

Mr. Butler: That concludes the petitioner's case, your Honor.

Mr. Constable: That is all I have, your Honor.

The Court: The witness is excused.

(Witness excused.)

The Court: Both parties rest?

Mr. Butler: Yes, your Honor.

Mr. Constable: Respondent rests, your Honor.

The Court: Mr. Constable, how many days for brief? I am addressing you because I think you are the burdened party as far as briefs are concerned at this time.

Mr. Constable: I wonder, your Honor, if I could have 60 days perhaps on it, say, 60 and 30.

Mr. Butler: Anything that is convenient for Mr. Constable is fine. We would prefer to get it out sooner than that but whatever Mr. Constable and the Court decide is fine.

The Court: I would rather make it 45, it seems you could do it, it is easier to do it and be lenient if you can't. Sixty days and thirty days would mean that I couldn't reach this case until July sometime. And I would prefer 45. I think I could get to it in June, if we got the brief in in 45 days. If you cannot do it, of course you can request an extension.

Mr. Constable: I am quite familiar with that procedure, your Honor. [68]

The Court: So is the Court.

Simultaneous briefs in 45 days, answer 30 days thereafter. The record will also remain open for 30 days from today for submission of a supplemental stipulation of facts covering the minutes of those four directors meetings. Of course if the stipulation can be filed prior to that time the Court would be glad to receive it.

Mr. Butler: We will try to get it here by Thursday, your Honor, if we can.

The Court: Will you announce the dates, Mr. Clerk.

The Clerk: The opening dates due May 1, 1958, and reply briefs May 31, 1958.

The Court: The case stands submitted.

The Court stands in recess until 10 o'clock tomorrow morning.

(Thereupon, at 5:20 o'clock, p.m., Monday, March 17, 1958, the hearing was closed.) [69]

[Endorsed]: T.C.U.S. Filed April 11, 1958.

The Tax Court of the United States

Docket No. 68,408

WILBUR SECURITY COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DEPOSITIONS OF GRACE LEWIS PHILLIPS
AND JOHN McPHERSON

Be It Remembered that on the 8th day of November, 1957, at the hour of 10:00 o'clock, a.m., at the office of Wilford H. Payne, Assistant Regional Counsel, San Francisco Region, Internal Revenue Service, United States Court House, Seattle, Washington, pursuant to stipulation, personally appeared before me, James R. Royse, a Notary Public in and for the State of Washington, County of King, duly appointed and commissioned to administer oaths:

Grace Lewis Phillips called to testify by deposition at the instance of the petitioner;

Francis J. Butler, Esq., and Paul Castoldi, Esq., Attorneys at Law, appearing for and on behalf of

petitioner; Nelson P. Rose, Esq., Chief Counsel, Internal Revenue Service, by Wilford H. Payne, Esq., Assistant Regional [1]* Counsel, San Francisco Region, Internal Revenue Service, appearing for and on behalf of respondent;

Whereupon, the following proceedings were had and done, to-wit:

Mr. Butler: I want to say for the purpose of the record that these depositions are being taken in accordance with the stipulation to take depositions which has been filed in this case, signed by Mr. Castoldi as counsel for the petitioner and by Nelson P. Rose and Mr. Payne as representing the Chief Counsel's office, Internal Revenue Service.

Mr. Payne: Mr. Nelson P. Rose is Chief Counsel, Internal Revenue Service, and he is counsel for the Commissioner of Internal Revenue.

I think the record should also show, Mr. Butler,—I assume Mr. Castoldi and Mr. Butler are both of record?

Mr. Castoldi: That is correct.

Mr. Payne: I assume the record should show these depositions are taken by stipulation and at the expense of the petitioner, and these are petitioner's witnesses.

Mr. Butler: That is correct.

Mr. Payne: And the cost of the depositions is to be paid by the petitioner.

Mr. Butler: That is certainly correct. [2]

(Discussion off the record.)

* Page numbers appearing at bottom of page of Original Deposition.

GRACE LEWIS PHILLIPS

being first duly sworn, testified on oath as follows:

Direct Examination

Q. (By Mr. Butler): Mrs. Phillips, would you state your name for the record, please?

A. Grace Lewis Phillips.

Q. And your address?

A. 1617 Sylvester Street, Olympia, Washington.

Q. Are you the Grace Phillips who is at the present time a stockholder and a note holder in the Wilbur Security Company? A. I am.

Q. Now, we are dealing here in the Wilbur Security Company case with facts that involve the years 1915 to the present time. Would you state for the record the other names that you might be referred to by in these records of the Wilbur Security Company throughout the years?

A. Grace Lewis Farnsworth was my maiden name, and my name by my first husband was Grace Lewis Fisk, or Mrs. E. M. Fisk.

Q. The records of the Wilbur Security Company show an [3] E. L. Farnsworth as one of the original incorporators. What relation is he to you?

A. Edward Lewis Farnsworth was my father.

Q. And the records also show a Sarah A. Farnsworth. What relation was she to you?

A. She was my mother.

Q. And they are both deceased at the present time? A. They are.

Q. Now, would you please tell us when you first became aware of any Wilbur Security Company?

(Deposition of Grace Lewis Phillips.)

A. After my marriage in 1918 my father customarily sent me a simple record of accounting of what moneys I had. He handled my business for me, and he sent it so that it could be incorporated with the earnings of Mr. Fisk, my husband at that time, for income tax purposes. After his death in 1926, he turned over such moneys to me with the accounting.

Q. Now, during the years 1952, 1953 and 1954, which I might explain are the taxable years involved here, you held an account in what is termed on the books of the Wilbur Security Company as a "note payable account," is that correct?

A. That is correct.

Q. Do you know the difference between a note and a stock contribution? [3-a]

A. Yes, I do.

Q. Would you explain in your own words what you think the difference is?

A. A stock represents a share in a company for which you hold certificates, and with stock you have voting rights and you obtain dividends from the stock.

Q. Speaking now about the amount outstanding in the "note payable account" of the Wilbur Security Company, in your opinion what was the nature of that account?

Mr. Payne: I object to that question as calling for the conclusion of the witness, namely, her opin-

(Deposition of Grace Lewis Phillips.)

ion of accounts and the nature of them, as being improper.

Mr. Butler: I think I may say for the record that the crux of this particular matter is the intent of the parties involved with regard to the "note payable account," and that our position is that Mrs. Phillips can certainly give her opinion as to what she considered the nature of the "note payable account" to be.

Q. I would like to ask you again, in your opinion what was the nature of the amount outstanding in the "note payable account" of the Wilbur Security Company from 1950 to the present time?

A. Well, it represented a loan to the company. I had no voting power; I had no stock interest in the company; [4] and I received only interest; I didn't receive dividends.

Q. When was the first time, Mrs. Phillips, that you heard that the Government was contending that the amount in the "note payable account" was a stock contribution as opposed to a loan?

A. Last year—1956.

Q. Going back, if I may, to earlier years, Mrs. Phillips, and again talking about the "note payable account" or the stockholder account, or whatever it might be known as, did you ever discuss this account with your father?

A. Yes, I did.

Q. And would you kindly state the nature of that conversation?

A. Before my father's death he told me that that money was there on loan; that it was in a very

(Deposition of Grace Lewis Phillips.)

liquid form; that he had put it there so that I could withdraw it to pay inheritance taxes, and that by notifying the bank when I would need the money, or the officers of the bank when I would need that money, that it could be taken out and so used.

Q. As I understand, then, you understood that you could draw down this amount upon proper notice? A. I did.

Q. Did you cash in or draw upon this account?

A. I did.

Q. Would you explain when and why? Did you do it after 1950? A. Yes.

Q. Would you explain the nature of that?

A. When my father's inheritance tax was paid, I drew funds from that account up to the amount of \$69,000, and at the time of settling my mother's estate, I again drew on that account to the tune of \$14,000.

Q. Can you tell us how you went about drawing that \$14,000? Did you call——

A. (Interposing) I just can't remember exactly whether I telephoned or wrote Mr. McPherson or Mr. Thompson over at the bank. I mean, sometimes I telephoned and sometimes I wrote. Probably I telephoned because it was easier to keep things straight. When you talked to a person personally you can keep things straight, and I would tell them I would need certain amounts, and what time I would need them.

Q. You don't know how that transaction was handled on the books of the Wilbur Security Company? A. I didn't see the books.

(Deposition of Grace Lewis Phillips.)

Q. Now, concerning the year 1954, did you treat the amount received as interest from the Wilbur Security Company as a dividend on your income tax return? [6] A. Yes.

Q. On your tax return? Do you understand the question? A. State it again.

Q. Did you treat the interest received in 1954 as a dividend?

A. No, I didn't treat it as a dividend; I treated it as interest.

Q. You didn't take the dividends received?

A. The dividends were always credited to my mother's estate until the estate was finally settled in August, 1955.

Q. Now, would you, if you had been requested, have subordinated this amount in the loan account to other creditors?

Mr. Payne: I object to that question for the purpose of the record as calling for a possible state of mind or conclusion which this witness was never called upon to give, upon the ground that it is merely a hypothetical or contingent possibility.

Q. Do you understand the question?

A. I think I do.

Q. Would you have subordinated this amount to other creditors? A. No, I would not.

Q. Do you own a stock interest in the Wilbur Security Company? A. I do. [7]

Q. When did you acquire that stock interest?

A. I inherited it from my mother when the estate was settled in August, 1955.

(Deposition of Grace Lewis Phillips.)

Mr. Butler: I have no further questions.

Cross Examination

Q. (By Mr. Payne): Mrs. Phillips, did you inherit any stock from your father?

A. My mother had all the stock from my father's estate, and I didn't inherit any until after her death.

Q. So when you inherited your mother's interest in 1955, that really represented the interest that your father formerly had before his death?

A. His interest and her community interest, yes.

Q. And your father died before your mother?

A. He died in 1940.

Q. And your mother died in 1955?

A. In 1951.

Q. In 1951. So what stock interest did you acquire at that time, Mrs. Phillips?

A. I acquired a stock interest in both the bank and the security company, after my mother's death; I mean, after her estate was settled.

Q. Do you remember the amount of stock in Wilbur that you owned at that time? [8]

A. I am not sure, Mr. Payne. I could take a guess at it, but I am not sure; I would have to check.

Q. The records would show it?

A. Yes, I am sure they would.

Q. Mrs. Phillips, you state that you also acquired the interest that your parents had formerly owned in the bank. Will you identify that bank?

(Deposition of Grace Lewis Phillips.)

A. The State Bank of Wilbur.

Q. Do you know the extent of that stock interest which you acquired in the bank?

A. The record will show. I think I know, but I wouldn't want to give sworn testimony as to what was the number of shares without checking it.

Q. Approximately, was it a large or small percentage?

A. I think it was ninety shares, but I am not sure; I never try to remember things I can look up, which are figures.

Q. You are talking about the bank?

A. I am talking about the bank, and I think it was that, but I am not sure. You understand, I don't swear that that is the amount without checking it.

Q. I am just asking you what you know about it. You just testify what you know about it. Do you know how much outstanding stock there was in the bank at that time? [9]

A. No.

Q. Did you become an officer in the bank?

A. No.

Q. Did you become an officer in Wilbur Security Company?

A. No.

Q. Is it your understanding that the bank interest had been owned by your father simultaneously with his interest in the Wilbur Security Company?

A. May I ask you what you mean by simultaneously? I know that one is not as old as the other, so they could not be simultaneously from the beginning.

(Deposition of Grace Lewis Phillips.)

Q. Which is the older? A. The bank.

Q. And the Wilbur Security grew out of that operation, did it?

A. I don't know; I can't testify to that.

Q. You gave some testimony which I don't understand about 1926, when you had some money with your then husband, Mr. Fisk.

A. My husband, Mr. Fisk, died in 1926.

Q. And you had some money then?

A. I said,—I think what you are referring to, Mr. Payne, is the fact that after Mr. Fisk's death my father turned over what little moneys I had of my own to me for my use because my husband, Mr. Fisk, did not leave me [10] provided for.

Q. You said something about investing that money?

A. No, I didn't say anything about investing it.

Q. I beg your pardon.

A. I never had enough to invest.

Q. Mrs. Phillips, Mr. Butler asked you if you know the difference between notes and stock?

A. Yes.

Q. And you said you did. When did you acquire that knowledge?

A. I think it was as a very young girl that my father started teaching me, and I worked for a while for the Marine Bancorporation, and I had it very thoroughly pounded into my head at that time.

Q. Do you remember when you first made an advance of funds of any size to the Wilbur Security Company?

(Deposition of Grace Lewis Phillips.)

A. No, I can't tell you the exact date. My father would give me money as a young woman, and it was deposited there for me, but I can't remember the exact date. I think it was around 1918, but I am not sure.

Q. Would you be able to say where that money came from?

A. Probably as gifts from my father, or he had given me a little stock as a young girl, and he probably took the interest and made up some of it that way, but I couldn't testify with accuracy as to where it came from. [11]

Q. Do you remember now how that amount increased or decreased over the years from that time down to the present?

A. Largely from gifts from him or from interest. The interest was always just redeposited there.

Q. Did you have some other stock that you acquired in those earlier years? A. Yes.

Q. Did you have some bank stock?

A. No.

Q. Where did these stocks come from that you acquired?

A. Well, I had some from my first husband, and I had some from my own earnings, and some as gifts from my father.

Q. Which predominated?

A. Gifts from my father.

Q. Did you ever receive a note from Wilbur Security Company with respect to the moneys which you had on deposit there?

(Deposition of Grace Lewis Phillips.)

A. No, I don't think I ever did.

Q. Can you say that you had money on deposit with the company at all times since about 1918?

A. As far as I know, yes.

Q. And the amount has varied somewhat, do you think, or can you testify to that?

A. I can't testify, but I am quite sure it has varied. [12]

Q. It usually increased, is that correct?

A. So far as I know, Mr. Payne. I never drew any money from that account until it was necessary, as taking that out for inheritance tax purposes for the estate of my father and for my mother.

Q. Let me ask you this: Do you remember or do you know whether you always received some return on that deposit? You may call it interest and we may have some other term for it, but did you receive some return on that deposit in each of the years since your original deposit, or do you know?

A. I am not absolutely sure, but I think there were times,—there were bad times when there was no interest paid. I am not absolutely sure, but I think I have a recollection of my parents saying there would be no money forthcoming from Wilbur in certain years that were bad years, but I can't testify positively.

Q. What explanation did your father give you with respect to those bad years, as you call it?

A. Hard times and bad crops. I think I

(Deposition of Grace Lewis Phillips.)

shouldn't perhaps testify to that. I know there were years when there was no money.

Q. I am just asking you to testify to what you know and can remember. Can you tell us this, for the record: When you had a skip year, for example, was the amount [13] which normally should have been expected for that year made up to you at some subsequent time?

A. I would have no knowledge of that because my father handled my business in his own way.

Q. Let me ask you again about this so-called interest—and I am sure we are not limited by the meaning of terms here, because that is the purpose of this proceeding, the legal effect of them—did you receive it in cash, in check or by credits on the books, or do you know?

A. I don't know. I mean, as far as any money I actually received was concerned, my father would send me a check which included what he would give me, or what little income I had.

Q. Did you customarily get a payment, or did you customarily get a credit or notice of the amount of credit to your account?

A. I customarily got from my father at the end of the year an accounting which showed it so that it could be taken care of for income tax purposes.

Q. Mr. Butler asked you if you had discussed these matters with your father, and you said you had discussed them with him, and that he indicated to you that you could withdraw those amounts. That was just a general understanding? [14]

(Deposition of Grace Lewis Phillips.)

A. I don't know what you mean by "a general understanding." It was a pretty definite understanding by me that they were there, because he told me prior to his death that they were there for the purposes I needed them.

Q. As long as he was alive, you would work through him, would you not?

A. He always took care of everything until about two months before his death, when he knew, —he had a cancer operation, and he knew he needed to teach me, and at that time he went pretty thoroughly into business affairs with me.

Q. Did you know at that time that his financial interests were going to your mother?

A. No, I knew nothing about his will until after——

Q. Until after he died? A. No.

Q. Did you know what provision was made for you at all by your father?

A. Not what provision was made by his will. He had given me during the years enough so that he had built up a slight income for me during the years, and he had educated me so that I was perfectly capable of looking after myself.

Q. Did your mother make a will?

A. She did. [15]

Q. Did you know about that? A. Yes.

Q. Did you know you were the beneficiary of her will?

A. I am her only child; naturally, there was no one else.

(Deposition of Grace Lewis Phillips.)

Q. When did you know it?

A. Right after my father's death she was told by the lawyer she should make out a new will.

Q. And that was in—— A. 1940.

Q. ——1940. From that point forward you were quite familiar with the situation, and that you were the expectant recipient of the stock interest of the bank and Wilbur Security that your father and mother had owned? A. That is right.

Q. Had your mother made a will by 1940?

A. You mean prior to the death of my father?

Q. Yes.

A. Yes, I think they both had wills.

Q. Was that same will in force when your mother died? I mean, did she make any different will——

A. (Interposing) She made a new will immediately after my father's death. I have already stated that.

Q. Mr. Butler asked you about how you reported the money you received from Wilbur Security, this so-called interest, in your 1954 return. I believe he asked you [16] whether you reported it as interest or dividends. Do you recall that?

A. Yes.

Q. You said you reported it as interest?

A. Yes.

Q. Do you know what difference it would make in your return, whether it was reported as interest or dividends?

A. No. I know there is a difference, but I don't

(Deposition of Grace Lewis Phillips.)

know what it is. In other words, a C.P.A. takes care of it.

Q. You were relying on the advice of someone else—— A. Certainly.

Q. ——and if someone else told you to call it dividends, but that was not the right way to call it, you would follow that advice, wouldn't you?

Mr. Castoldi: I object to that question.

A. I object to that question, too, because I know the difference between interest and dividends, and I don't let anyone tell me. I make up my own report to them, and I know what is interest and what is dividends when I turn it over to them to prepare the return.

Q. Did you make up your own return?

A. I did not.

Q. You turned over the factual information and they made it up? A. That is right. [17]

Q. Would you question how they reported income as interest or dividends, or would you follow their advice?

A. I don't deal with people who actually call interest dividends, or dividends interest. I give them the facts of what I know of my income, and they make up the return accordingly. I deal with one of the most reliable C.P.A. firms in the country.

Q. You rely on his judgment largely in those matters?

A. I give him the facts, and he makes it up according to the way he is supposed to make it up.

Q. Are you familiar with the statutory definition

(Deposition of Grace Lewis Phillips.)

of a dividend and in the Internal Revenue laws so far as a corporation is concerned?

A. I probably couldn't quote it, no. No, I wouldn't testify to that.

Mr. Payne: That is all.

Mr. Butler: I want to clear up a couple of questions.

Redirect Examination

Q. (By Mr. Butler): You testified earlier on cross examination by Mr. Payne that when you called Wilbur concerning the fact that you wanted to get money for your taxes and your mother's estate, that you called the bank. Did you mean you [18] called the bank or you called——

A. I meant Mr. McPherson, or Mr. Thompson, who was then living, and who would naturally always be found at the bank during business hours. I mean it was the officers or the people handling the business for the Wilbur Security that could always be found at the bank during banking hours. The people whom I wanted to talk to would be Mr. McPherson or Mr. Godfrey Thompson.

Q. You mentioned also in your testimony, or Mr. Payne elicited, that you owned ninety shares. Was that ninety shares in the Wilbur Security Company, or the bank?

A. In the Wilbur State Bank; and I also testified I wanted to check those figures to be very sure.

(Deposition of Grace Lewis Phillips.)

Q. Do you know how many shares you own now in the Wilbur Security?

A. I am sorry; I don't know.

Q. Did you have any interest in the Wilbur State Bank in the earlier years—any stock interest? A. No.

Q. Now, Mr. Payne asked you if you ever received a note from the Wilbur Security evidencing these amounts, and you said no. Were notes issued evidencing these amounts?

A. So far as I know, there were notes, yes, in Wilbur from the time my father,—away back in his day, that were [19] just customarily and automatically renewed, and they just continued that when I took over the business.

Q. Now, would you state for the record how you dealt with Mr. McPherson? There is the elder Mr. McPherson and the younger McPherson. Concerning these business matters, how did you customarily deal with them?

A. I usually called them on the telephone because I could get a quick answer, and if there is any explanation needed, it is forthcoming, and we could discuss it right on the phone. It is much easier and quicker than writing.

Q. Have you ever discussed this method of doing business with your present attorney who handles your legal matters?

A. May I add, I also go into Wilbur once a year, where we have a very thorough talk on business matters.

(Deposition of Grace Lewis Phillips.)

Q. Did you ever talk about this method of dealing with the McPhersons with your present attorney?

A. He knows how I handle it.

Q. What did he say about it?

A. Well, he thought it was a rather nonchalant way, but having met Mr. McPherson and knowing the relationship between the two families, he began to understand it.

Q. Now, you testified with regard to the amount outstanding in the Wilbur Security account payable or the stockholder account that you discussed it with your father. [20] Did you also have any conversation about whether you could draw this money when you were out of town or traveling?

A. Yes, I always knew from the time I was a young woman that I could draw on that and not be caught stranded somewhere.

Q. Mr. Payne also asked you whether you actually received the interest each year, and, frankly, I didn't understand your answer. How was that handled, to the best of your knowledge at the end of the year,—the interest payment on the "note payable account" in the Wilbur Security Company?

A. Up to Mr. Fisk's death I never received any of this money. After Mr. Fisk's death my father used to give me a monthly allowance, which included what income I had, but how he divided it up or when he got it or what he did, I don't know.

Q. How about at the present time?

A. What do you mean?

(Deposition of Grace Lewis Phillips.)

Q. With regard to these interest payments at the present time, how are they handled?

A. Well, they are usually left there in Wilbur—left in the account the last few years. The last year was the first year I haven't paid inheritance tax or finished paying the inheritance tax. This will be the first [21] year I haven't needed to have money for those purposes.

Mr. Butler: I have no further questions.

Recross Examination

Q. (By Mr. Payne): Mrs. Phillips, you seemed to change your testimony about these notes. You stated on your first cross examination that you never received the notes with respect to those amounts so far as you can recall?

A. That is right.

Q. And then on Mr. Butler's redirect, you stated, as I remember it, that notes were customarily and automatically given and renewed.

A. I think if you will go back to my very first testimony, Mr. Payne, I stated that it was my father's custom to just leave the notes there and automatically renew them, and that has continued. I think if you will go back to the very first time Mr. Butler asked me about it, you will find that is what I said.

Q. Let me ask you specifically about your own deposits. Did you ever see a note with respect to your own deposits?

A. No, I don't think I ever did.

(Deposition of Grace Lewis Phillips.)

Q. And when you say they were customarily and automatically renewed, that is just hearsay from your father? [22]

A. I don't know whether it is hearsay; it is just a thing that happened. That was the way it was handled.

Q. How do you know it happened?

A. I know it happened that way.

Q. Tell us for the record how you know it happened.

A. I know I had to have some receipts for it, and that it is there if I went and asked for it.

Q. But you didn't receive one yourself and you didn't see any other notes and you didn't see and examine the books and records of the corporation, did you?

A. The books and records of the corporation were examined by my lawyer at the time of settling my father's estate, and I am quite sure at that time he undoubtedly saw those notes. They were seen. I wouldn't know what papers were brought into evidence at that time.

Q. Then your answer is that any information that you have on that subject came through someone else, and you didn't physically see it, or know personally about the way in which it was handled?

A. I may have seen it at the time of the settling of the estate, but I can't recall because there were too many things.

Q. Where did you get the information on which

(Deposition of Grace Lewis Phillips.)

you base your statement that the notes were customarily and automatically renewed? [23]

A. Well, I know that my father had some evidence of it. He had the notes, and I know he just simply called the boys, exactly as I do, and the notes were taken care of in that way.

Q. That is an assumption on your part, isn't it?

A. What is the difference between an assumption and knowledge? I know that father——

Mr. Butler: That is all right; just answer the question.

Q. I don't want to argue with you; I just want you to tell for the record. That testimony is based on what someone else told you?

A. I can't go back to the time we examined all the books at the time my father's estate was settled, but I think at that time I probably may have seen them.

Q. Then you stated on redirect examination that once a year you went to Wilbur, and there you had a thorough discussion. When did that begin, so far as you personally are concerned?

A. After my father's death and I had to handle the business.

Q. I believe you testified, though, that you did not acquire any interest upon your father's death, and not until your mother's death?

A. No, but I was administratrix of her estate, and I had to handle all the affairs, and they were gone into—— [24]

Q. Prior to her death in 1951?

(Deposition of Grace Lewis Phillips.)

A. I mean my father's estate. I was administratrix of his estate and her estate, and I handled her business affairs after his death.

Q. You gave some testimony on redirect with respect to the "note payable account." Do you know how that account was carried on the books?

A. I am sorry; I didn't understand you.

Q. Mr. Butler just asked you a moment ago on redirect examination about these amounts in the "notes payable account." Do you know anything about the terminology—meaning that account,—except what someone else told you? Do you know how the account was carried by the corporation?

Mr. Butler: I object to that. I merely characterized it as a "note payable account," because that is the way it is characterized in the books, for the purpose of identification.

Mr. Payne: When you asked her, she assumed that was a fact, and I am asking what she knows about the "notes payable account."

A. I know when I got my report from Wilbur,—the information for the income tax, which would have been mine,—the estate's, and my own, it was written, "Wilbur Security Co. dividends; Wilbur Security Co. interest; State Bank of Wilbur dividends." [25]

Q. So you don't know the name of the account on the books?

A. Yes, I know the name of the account. It was held in my name, and the other account was held in my mother's name or the estate's name.

(Deposition of Grace Lewis Phillips.)

Q. I mean whether the corporation carried it a a "notes payable account," or some other designation?

A. I never saw it.

Mr. Butler: One other question.

Redirect Examination

Q. (By Mr. Butler): Do you have income in addition to the amount you are receiving from the Wilbur Security Company and the Wilbur State Bank?

A. Yes, I do.

Q. Is that in excess of the amounts received from the Wilbur Security and Wilbur State Bank?

A. Yes.

Mr. Butler: I have no further questions. [26]

/s/ GRACE LEWIS PHILLIPS.

[Title of District Court and Cause.]

Be It Remembered that on the 8th day of November, 1957, at the hour of 10:35 o'clock, a.m., at the office of Wilford H. Payne, Assistant Regional Counsel, San Francisco Region, Internal Revenue Service, United States Court House, Seattle, Washington, pursuant to stipulation, personally appeared before me, James R. Royse, a Notary Public in and for the State of Washington, County of King, duly appointed and commissioned to administer oaths:

John McPherson called to testify by deposition at the instance of the petitioner;

Francis J. Butler, Esq., and Paul Castoldi, Esq., Attorneys at Law, appearing for and on behalf of petitioner; Nelson P. Rose, Esq., Chief Counsel, Internal Revenue Service, by Wilford H. Payne, Esq., Assistant Regional [1] Counsel, San Francisco Region, Internal Revenue Service, appearing for and on behalf of respondent;

Whereupon, the following proceedings were had and done, to-wit:

JOHN McPHERSON

being first duly sworn, testified on oath as follows:

Direct Examination

Q. (By Mr. Butler): Will you state your name for the record, please?

A. John McPherson.

Q. And your address?

A. Wilbur, Washington.

Q. Your age?

A. I will soon be seventy-eight. I am seventy-seven, and I will be seventy-eight this month.

Q. When did you first come to Wilbur?

A. February, 1902.

Q. Would you tell us how you happened to come to Wilbur in the first place?

A. I came here to work in the bank as a book-keeper.

Q. What was your position in the bank?

A. Well, I was bookkeeper when I first came, and later on I was assistant cashier. [2]

Q. Anything else? A. I was president.

(Deposition of John McPherson.)

Q. So then you were an officer of the Wilbur State Bank from 1902 until recently?

A. Yes, approximately so until recently.

Q. You were one of the originators or one of the original people in the Wilbur Security Company? A. Yes.

Q. Which was formed in 1915, as the record in the case indicates? A. Yes.

Q. Would you tell us the circumstances which either necessitated or surrounded the forming of the Wilbur Security Company? Would you tell us something about it, and how the company started?

A. Well, the Wilbur Security was formed for the purpose of holding long-time paper which the bank was not permitted to carry,—excess loans that the bank couldn't carry. I don't know if you people understand that in the banking business we are only allowed to carry on the books ten per cent of our capital and surplus. Some customers required more time, so we formed the Wilbur Security Company in order to hold the customers.

Q. How much was put up at the outset for Wilbur Security Company? [3]

A. Originally we put up \$200,000—\$25,000 and \$200,000.

Q. What was the nature of the two hundred thousand?

A. The nature of the two hundred thousand was accounts we had in the State Bank of Wilbur on deposit.

(Deposition of John McPherson.)

Q. Was there any reason for putting it in the Wilbur Security Company?

A. Oh, yes, there was a reason. The reason we did it was because that they were always talking in those days about starting a new bank, and that money belonged,—most of it belonged to Mr. Farnsworth and myself, and my dad, and we put it over in Wilbur Security Company so the bank wouldn't have that amount of deposits that showed. It invited a competition if we showed deposits were more than they really were. That was the idea. So we put it over in order to get it out of the bank.

Q. Did you intend at that time that this money be placed at the risk of the business,—the two hundred thousand dollars? A. No.

Mr. Payne: Objected to as calling for the conclusion of a witness on a point which the Court must decide.

Q. You can testify on your intent. Did you intend that to be at the risk of the business?

A. No, sir. [4]

Q. How much would you have needed in your opinion to start the Wilbur Security Company originally?

A. Oh, to start it we would not need much more than a capital of twenty-five thousand dollars.

Q. Did you give any consideration at the outset to the income tax laws—at the outset of Wilbur Security?

A. No, not the income tax laws in those days.

(Deposition of John McPherson.)

The income tax didn't amount to anything. We never even thought of income tax.

Q. You were an officer in Wilbur Security Company, is that correct? A. What?

Q. You were an officer in the Wilbur Security Company? A. I am not now; I was.

Q. I say, you were?

A. Yes, I was, from the inception of it.

Q. From 1915 to 1939 were you an officer?

A. I was.

Q. Now, you were also a stockholder?

A. I was a stockholder.

Q. And you also in those years, 1915 to 1939, had amounts outstanding in this so-called "stockholders' account"? A. That is right.

Q. Did you also have amounts outstanding in an account known as the "special account"? [5]

A. I did, yes.

(Discussion off the record.)

Q. How did you in your own mind characterize the amounts outstanding in the "stockholder account" and the "special account" from 1915 to 1939?

A. I considered them loans to the company.

Q. Could you have withdrawn those sums?

A. Yes, I could.

Q. Did you ever withdraw any?

A. I think I did at times. We did at one time withdraw some.

Q. How about with regard to the "special account"? A. Yes, I withdrew some.

(Deposition of John McPherson.)

Q. That account fluctuated, the record will show? A. Yes, but not too much.

Q. Did you surrender any stock when you took back some of this amount that was outstanding?

A. No.

Q. As to these amounts in these two accounts, the "stockholder account" and the "special account," from 1915 to 1939 did you have any notes for these amounts?

A. No, we didn't up to 1939, no.

Q. Why didn't you have?

A. The reason we didn't do it was because in those days we were permitted to pay interest on open accounts, but [6] after that we weren't on account of the Revenue Department. They insisted we could only allow interest on notes.

Q. In 1939 the minutes of the corporation show that the "stockholder account" and the "special account" were consolidated. The minutes indicate that? A. Yes.

Q. The "stockholder account" was, according to the minutes, paid off. What were the mechanics of that transaction, if you recall? Did you actually receive the two hundred thousand dollars at that time? A. My portion of it.

Q. You did receive your portion of it?

A. Yes, I did receive it.

Q. And what did you do with it?

A. I put it in my account.

Q. In your account?

(Deposition of John McPherson.)

A. Moved it into the,—consolidated it with my own account.

Q. Was it just a book transaction?

A. Just a book transaction, yes.

Q. But it was your understanding that that was——

A. (Interposing) That it was a book transaction.

Q. Now, I am talking about 1939 again, when this consolidation took place. Did you have notes evidencing [7] the amount of that special account?

A. Yes, I did.

Q. In 1939?

A. I beg your pardon. I never had notes until—it was some time after that that we had notes.

Q. How would you characterize in your mind the amount outstanding in the “special account”? How would you characterize it?

A. I would characterize it as a loan to Wilbur Security at that time.

Q. Did you at that time have the same ratio of stock and account ownership? A. No.

Q. Was the ratio between stock ownership and your account the same? A. No.

Q. Was this amount in the “special account” at the risk of the business? A. No.

Q. Why wasn't it?

A. Well, because it was subject to withdrawal. It was just a loan.

Q. Would the amount outstanding in the “spe-

(Deposition of John McPherson.)

cial account" have been prior to the stock ownership if the company had folded up? [8]

Mr. Payne: I object to that as calling for a conclusion of the witness on a point the Court has to decide.

Q. Would you, in effect, be ahead of the stock by virtue of this "special account"?

Mr. Payne: I object to that as calling for a legal conclusion.

Q. You may answer. A. No.

Q. I will rephrase the question. You had an amount outstanding in the "special account"?

A. Yes.

Q. And you had a stock ownership?

A. Yes.

Q. If the company had gone defunct for some reason, would your amount in the "special account" have taken precedence over the stock account?

Mr. Payne: That calls for a conclusion and the respondent renews the objection.

Q. You may answer.

A. Yes, I think it would.

Q. Now, in 1943, the minutes of the corporation indicate that a new account was set up called "notes payable account," and it was set up by transferring over the old "special account" balance. The minutes indicate [9] that the directors were to issue notes. Now, my question is, were notes issued in 1943?

A. Yes, there were.

Q. What kind of notes were they?

(Deposition of John McPherson.)

A. Promissory notes. Just notes payable to the depositors who wanted to put money in it.

Q. Did you get one? A. Yes, I did.

Q. Was it renewed each year?

A. Yes. I think there were two or three years——

Mr. Payne: Let me stop right at this point. We are going to object to this testimony as not being the best evidence.

Mr. Butler: The best evidence rule applies to contracts, wills and leases, and would have no applicability.

Mr. Payne: You are asking now about notes to cover hundreds of thousands of dollars over periods of time, and I object on the ground that this witness cannot be expected to remember all the details of those accounts, and I am calling for the best evidence.

Mr. Butler: I will get to that.

Mr. Payne: I just want it understood I am going to object to it.

Mr. Butler: All right. Fine. The objection [10] is noted.

Q. Were the notes renewed each year?

A. My own, the one I got, is in my safety deposit box.

Q. I am talking about the years 1943 to 1950. You have testified you had notes,—notes were issued, and that you had a note?

A. I had a note, yes.

Q. Were they renewed each year?

(Deposition of John McPherson.)

A. I think they were. There might have been a year or two, but they were renewed because interest was always paid on them, which renews them.

Q. What happened to the note? Did you turn it in and get a new note each year?

A. Yes, mostly we did. There was a year or two I don't think we did.

Q. Where are those notes now?

A. My note is in my own possession.

Q. I am talking about the old notes?

A. Oh, I don't know.

Q. What happened to the old notes?

A. What happened to the old ones? I kept some of those, and what happened was that we had a flood over our way, and we had them all stored in the basement, and all our files down there were ruined by the mud and water coming in and ruining everything in the basement,—the Security [11] Company files and my files. I had my private files down there. It ruined all them. Most of them were just destroyed, but the old notes weren't any good. We didn't figure there was any need to keep them, but I used to keep them——

Q. That is all right. I have a picture that I am going to try to add to this stipulation.

(Discussion off the record.)

Q. We were talking about your notes of the Wilbur Security Company being in this building.

A. Yes, my own.

Q. Now, I am talking about the "notes payable account," which came into being in 1943. How

(Deposition of John McPherson.)

would you in your own mind characterize the amount that you had outstanding in that account?

A. Well, it was a loan to the company,—an amount to me from the company.

Q. You understand, Mr. McPherson, that we are at issue here concerning the nature of the amount in this account,—whether it was a loan, or whether it was a contribution of capital?

A. It was a loan.

Q. I am going to ask you, do you recall if in other years you had this same argument with the Internal Revenue Service concerning what was the nature of this account? [12] A. Yes.

Q. Do you remember when that was?

A. Oh, that was along in 1938 or 1937,—somewhere along in there.

Q. Did any Internal Revenue agents investigate the account in the early forties, or the forties?

A. Yes.

Q. Was this question ever brought up at that time? A. Oh, yes.

Q. And what was the result of it?

Mr. Payne: I object to that as calling for evidence from this witness which is not the best evidence. There must be some written responsible document.

A. The case was dismissed.

Q. The case was dismissed. Did you pay any additional tax?

A. No, we didn't pay any additional tax.

Q. Did you ever—and I am talking about the

(Deposition of John McPherson.)

amount outstanding in the "notes payable account,"—did you ever subordinate this amount to other loans? A. Absolutely not.

Q. Were you ever requested to do so?

A. Yes, we were requested at the time we made some loans, and we told them we would not do it.

Q. Now, the by-laws of the corporation, [13] which will be in evidence eventually, originally provided that if you transferred a share of stock in the Wilbur Security, you also had to transfer an eight-hundred dollar amount in the "special account." How long was this provision in effect, do you recall?

A. I think up until the thirties. I forget what year.

Q. Were the by-laws actually changed at that time? A. I don't think so.

Q. Were there amounts transferred after 1938, to your knowledge, which didn't include part of the accounts payable?

A. Yes, they were transferred. I think along about 1938, somewhere along there, they were consolidated with our other account.

Q. After 1939, when the new people came into the company, were they told about this provision in the by-laws?

A. Well, they knew about it, yes.

Q. Were they told about it? A. Sure.

Q. The people who came in after 1939?

A. You mean the new stockholders?

Q. Yes. A. No, not to my knowledge.

(Deposition of John McPherson.)

Q. Do you understand the distinction between a loan and a stock ownership? [14]

A. Oh, yes, sure.

Q. Would you explain in your own words what you think the distinction is?

A. Well, of course, a stock is capital of a company, and it has voting rights, whereas notes are just a loan representing money loaned,—a note given to a party for money due; that is a promissory note.

Q. How would you characterize the amount which you had outstanding in the “notes payable account” during these years in question?

A. Well, I would consider it a loan.

Q. Now, you had during the years 1915 to 1917 amounts outstanding in both a “stock account payable” and a “notes payable account” of the Wilbur Security Company, is that correct?

A. What is that?

Q. During each of the years 1915 to 1956 you had an amount outstanding in both the stock accounts,—you owned stock—and you also had an amount in the “notes payable account”?

A. Yes.

Q. Now, during some of these years was the value of this stock depressed? Did it go down some years,—the value of the stock?

Mr. Payne: I object to the question as calling for a conclusion. [15]

Q. You may answer.

A. What do you mean by “depressed”?

(Deposition of John McPherson.)

Q. During some years, the earlier years, did the value of the stock go down?

A. Maybe it did; it would probably fluctuate.

Q. Did this fluctuation have any effect on the "notes payable account"? A. No, not a bit.

Q. With regard to the non-stockholders like your sister—did she own any stock in the company? A. No, never did.

Q. Did this increase in stock values affect her "notes payable account" in any way?

A. Absolutely not.

Q. Are you a stockholder in the Wilbur Security Company at the present time?

A. No, not now.

Q. Are you a note holder?

A. Yes, I am a note holder.

Q. When did you sell your stock in the Wilbur Security Company? A. December, 1956.

Q. How much do you have now in the note account? A. \$197,000, I think. [16]

Q. Do you have any managerial rights in the company? A. No.

Q. Are you an officer of the company?

A. No, I am not.

Q. Is that \$197,000 at the risk of the business?

A. No, not at the risk of the business; it is a loan to them,—an out-and-out loan.

Q. Now, is Godfrey Thompson or his widow a stockholder and note holder in the Wilbur Security Company? A. Not now; we paid her off.

Q. When did you pay her off?

(Deposition of John McPherson.)

A. We paid her off last December.

Q. Is she still a stockholder?

A. She is a stockholder, yes.

Q. How about Mr. E. H. Oswalt? Is he still a note holder? A. No.

Q. Is he still a stockholder?

A. He is a stockholder, yes. He has been paid off. We paid him off. He needed it for reinvestment. He could get more interest than we paid, and he wanted his money, and we paid him off.

Q. Will you, by virtue of this amount outstanding in the "notes payable account" share in the profits of the company?

A. Not a cent. [17]

Mr. Payne: I object to that as calling for a conclusion of the witness, and I would like to move that the answer be stricken and let the record so show.

Q. Are you familiar with the interest rates that have been paid on this loan account over the years?

A. Yes.

Q. As a banker, would you characterize those amounts as an excessive rate of interest?

A. No, I never considered it excessive. I never considered five or six per cent an excessive interest rate.

Q. How large is Wilbur?

A. Oh, about 1100 people.

Q. How would you characterize or how would you state the nature of the relationship among the stockholders and the note holders in Wilbur Secu-

(Deposition of John McPherson.)

rity Company? Were they on a friendly basis? Would you care to comment on it? I mean, did they get along together or how did they get along?

A. Oh, they got along all right there.

Q. Would you say that business in a small town by a small town banker like yourself is conducted in the same manner that you would conduct a bank in Seattle or one of the bigger cities?

A. No, no; no, I don't think so. We are more intimate with our customers than they are. [18]

Mr. Butler: I have no further questions.

Cross Examination

Q. (By Mr. Payne): Mr. McPherson, you testified that you had held various positions in the Wilbur Security Company and various positions in the bank at Wilbur? A. Yes.

Q. Would you identify the name of that bank?

A. The State Bank of Wilbur.

Q. You gave some general testimony about the incorporation of the Wilbur Security Company, and Mr. Butler asked you how much money you put up. You first testified that you put up two hundred thousand dollars, and then you later referred to twenty-five thousand dollars? A. Yes.

Q. Do you remember how the twenty-five thousand dollars so-called capital stock was paid?

A. There was no capital stock paid in. The capital stock was built up from the earnings of the company.

(Deposition of John McPherson.)

Q. Why did you put in the two hundred thousand dollars?

A. Well, as I said, we put in the two hundred thousand dollars to get it out of the bank. It was all on open account in the bank to the credit of each individual that was a stockholder in the bank. You understand the [19] stockholders in the bank and the stockholders in the Security Company owned the stock in proportion.

Q. How long did that continue?

A. Oh, that continued up until,—I think it continued up until along about 1938; sometime in there, about 1938. (Pause.)

Q. Just use your best—

A. It is hard to remember offhand.

Q. Now, Mr. McPherson, what did Wilbur Security Company do with the \$225,000?

A. What did they do with it?

Q. Yes.

A. Well, we loaned it out. We loaned the money out and carried notes and real estate and mortgages, and so on.

Q. In the same type of operation as the bank had been engaged in?

A. Practically so, yes.

Q. How long did that continue?

A. It still continues. It has continued all the time I was in there. It has always continued that way.

Q. Are you familiar with the operation of Wilbur Security in the years 1953, 1954 and 1955?

(Deposition of John McPherson.)

A. I am, yes.

Q. Is it still loaning money?

A. Yes. [20]

Q. Does it own some farm lands?

A. Yes.

Q. Do you know to what extent the assets of the corporation were represented by farm lands and real properties in 1953, 1954 and 1955?

A. You mean the farm lands is the principal part of the company? A. Yes.

Q. That is the principal part of your earnings, too, isn't it?

A. Yes, the principal part of the earnings.

Q. You don't have any earnings from interest and dividends?

A. Oh, yes, we do; yes, we do.

Q. Do you know how much money was invested in farm lands in 1953, 1954 and 1955, relatively?

A. How much was invested in farm lands?

Q. Yes.

Mr. Butler: I request that that be clarified as to whether counsel for the Government means how much was invested, or what was the fair market value of the farm properties in the years in question.

Mr. Payne: This is cross examination. He may answer any way he wishes to.

Q. Do you know what amounts you had invested in farm lands in those years?

A. I can't remember the exact amount, but I imagine it was some \$500,000, or more. [21]

(Deposition of John McPherson.)

Q. That is all I want, your best judgment.

A. It is hard to remember.

Q. Were those lands owned outright by Wilbur Security? A. Yes, by Wilbur Security.

Q. Do you know when they were acquired?

A. At different times. A lot were acquired through foreclosure, and a lot were acquired through parties deeding them over to pay the obligation that they owed us.

Mr. Butler: I might, if I may interrupt, say we have a list of those farm lands which we intend to stipulate and will gladly indicate when they were acquired and for how much, and any further information regarding the same.

Mr. Payne: This testimony has been very general up to now, and I suppose we will keep it that way.

Q. From time to time in addition to the two hundred thousand dollars, Wilbur Security took from stockholders and from others large amounts of money on so-called loans, is that right?

A. That is right.

Q. Was that money used to acquire the farm lands?

A. Well, no, not—it was indirectly, yes. We used a lot of it to pay off the mortgages that was on them that came due, and it was for different loan purposes,—to [22] carry some large accounts that the bank couldn't take care of—overloans. We loaned money in order to hold the customers.

Q. So these so-called loans to the corporation really found their way into the substantial assets

(Deposition of John McPherson.)

which constitute the working capital of the corporation, did they not?

A. No, I don't think so. Of course, if we borrowed the money, we had to pay interest on the loan,—on the bills payable.

Mr. Payne: I am going to ask him some questions about this return and let him testify from his knowledge of the return and the figures in the return.

Mr. Butler: I object to giving him the return on cross examination on the ground that it exceeds the scope of the direct examination. You are asking him to testify about a return that he has no independent knowledge of, other than as an officer of the corporation. He didn't make out that return, and he would have to establish that he had something to do with making out the return other than just signing it as an officer of the company.

Mr. Payne: You may object to it, but I will make the record.

Q. I show you a document, Mr. McPherson, which is entitled, "Wilbur Security Company, Wilbur, Washington—United States Corporation [23] Income Tax Return 1953." At the bottom are two signatures, and I ask you if you can identify them?

A. Yes, that is my signature.

Q. As president of the corporation?

A. That is right.

Q. And G. Thompson is secretary of the corporation?

(Deposition of John McPherson.)

A. Yes; he has passed away. He isn't living now.

Q. I show you a so-called balance sheet attached to that return as of December 31, 1952.

A. Yes.

Q. Merely to refresh your recollection on the matter about which I asked you a moment ago, you stated that you recall that the farm lands were probably up around \$500,000?

A. It is \$439,000.

Q. \$439,503.07?

A. That is right.

Q. Which is stated in the assets account in that balance sheet?

A. No, it wasn't the total assets.

Q. I say, that is in the assets account?

A. Yes, it is in the assets account.

Q. That is the farm lands?

A. That is right. [24]

Q. Do you know whether that is based on value or on the cost?

A. That is on the cost—the actual cost of them.

Q. Now, I show you another schedule attached to that return for the year 1953, showing a list of so-called bills payable as of December 31, 1953, with a list of individuals and estates, and so forth, from whom those amounts were apparently secured, and ask you to give us the sum total of that list?

A. \$552,518.40.

Q. Do you think that any part of that \$552,518.40 is represented in the farm lands account just mentioned?

A. Represented in this?

Q. Yes.

(Deposition of John McPherson.)

A. It is not represented in this. That was the money we loaned the company.

Q. What happened to that money?

A. What?

Q. What happened to the \$552,518.40?

A. What happened to it?

Q. Yes, what did you do with this money?

Mr. Butler: I object to the materiality of that question.

Mr. Payne: Let the record show his objection.

Mr. Butler: I don't think it makes any [25] difference.

A. The company used it for investment, of course.

Q. Those investments are represented by your farm lands?

A. Not altogether; also bills receivable—other bills receivable. Farm lands is only part of it. Of course, that is a big part of it, but we loaned a lot of that money out for other purposes, too,—for notes and mortgages and so on.

Q. If the bills payable had been demanded in the sum of \$552,518.40, could Wilbur Security have paid this amount in 1953? A. Absolutely.

Q. Where would you get the money from?

A. We were offered it from several different sources. If we wanted it, we could have gone out and borrowed it any time. We have an open credit from a bank.

Q. You mean, you would have to borrow it in order to pay it off?

(Deposition of John McPherson.)

A. Well, yes, or call in some of our loans, or sell some of our farm lands.

Q. So that the so-called "bills payable accounts" were tied in the operations of the company, weren't they? A. Every company has that——

Q. And you couldn't have paid it off without borrowing the money or selling your farm lands, could you? [26]

A. Well, no, I don't suppose we could have without liquidating the company, or borrowing it; but we could have borrowed it. We were offered the money, and at different times we have to look for loans of our own. But we were offered the money to pay it all off, absolutely. It would have been very easy. We could have paid off.

Mr. Butler: Just answer the question.

(Discussion off the record.)

Q. Mr. McPherson, is it your understanding that the same relative situation continued with respect to the farm lands which were owned by Wilbur and the so-called loans account of Wilbur throughout the years 1954 and 1955?

A. 1953, 1954 and 1955.

Q. We just talked about 1953. I say, is it your understanding the same general conditions prevailed in the subsequent two years?

A. Yes, I think the same condition prevailed.

Q. There was no change in the relative position, was there?

A. I don't hardly think so. I don't know, but I don't think so. Maybe a minor change.

(Deposition of John McPherson.)

Q. You still owned substantially the same farm lands and other assets, and you still had these so-called bills receivable? [27]

A. There was probably some change in the bills receivable. They fluctuated up and down.

Q. There was some testimony about which I am not clear, and I am not sure the record is clear, on the difference between the "special account" and the "stockholders account." What is your understanding of the so-called "special account"?

A. My understanding of the "special account"? In what way do you mean?

Q. Mr. Butler asked you about those two different accounts, and you gave testimony about it on which I am not clear. Reiterate your understanding of the "special account."

A. The "special account" was just money loaned the company and any interest on it; that was all there was to it.

Q. Is that "special account" the original two hundred thousand dollars that you put in?

A. No.

Q. What was it?

A. I didn't put in the two hundred thousand dollars. That was the stockholders who put it up.

Q. I mean the stockholders. You are testifying now as a stockholder of the corporation too?

A. That is right.

Q. And an officer?

A. Yes. [28]

(Deposition of John McPherson.)

Q. Do you know how the two hundred thousand dollars was designated on the books?

A. Yes, "stockholders account."

Q. You say that was the "stockholders account"?

A. Yes.

Q. Then what was the "special account"?

A. The "special account" was just money that belonged to the individual people that they left with the company.

Q. Was one of those accounts subject to restrictions or limitations?

A. Not at all. There were no restrictions or strings to it at all.

Q. What about the two hundred thousand dollars that the stockholders put in at the time of the organization? Was that subject to any restrictions?

Mr. Butler: Would you clarify that as to time? Restrictions during what time?

Mr. Payne: At the time it was put up.

A. At the time it was put in, yes.

Q. What were those restrictions, if you know?

A. The restriction, as I understand it, was that whoever bought out the stock would have to put that much money in the company. Of course, that was at the time that we organized it.

Q. How many shares did the Wilbur Security Company issue in the beginning? [29]

A. 250 shares.

Q. At \$100 par?

A. One hundred dollars par.

Q. That is represented by the \$25,000?

(Deposition of John McPherson.)

A. The \$25,000.

Q. That was later put in out of earnings?

A. What?

Q. That was later put in out of earnings?

A. Yes, that is right. It built up from earnings.

Q. In 1916, or do you remember the year?

A. Some time in there, yes. I think it was some time in those years.

Q. Now, \$200,000 was put in subject to limitations, wasn't it?

A. Yes, I think the record will show it.

Q. That represented \$800.00 per share?

A. Well, in a way, I guess it did, yes.

Q. And it is your understanding the shares could not be assigned or transferred without the additional \$800.00 per share going with it?

A. No, I don't understand it that way.

Q. You don't? A. No.

Q. What do you understand? [30]

A. Would you let me explain it?

Q. Yes.

A. The reason we had it that way was that if the shares were put up for sale, we didn't want it to go outside. For instance, if anybody wanted to sell his shares, he would give the present stockholders the first opportunity to buy out that stock, and if we didn't want to accept it, he could go out and sell it on the outside and withdraw the money. But we wanted the right to buy it first if we wanted it. He could offer it to us first, and if we didn't take it at that price, then he could

(Deposition of John McPherson.)

go out and sell it to whoever he pleased. We reserved that right. Our by-laws will show that.

Q. Do you remember the resolutions of the corporation which were passed with respect to the \$200,000? A. Yes.

Q. Do you remember what those resolutions provided?

A. Well, not just word for word, I don't know what they provided; but they provided that that amount was to go with the stock, yes.

Q. And that the stock not be assigned or transferred without the proportionate part of the \$200,000 going with it?

A. Yes, it was at that time. You are speaking now of away back when we organized the company?

Q. Yes. A. Yes. [31]

Q. I believe you indicated that that condition was changed? A. Yes, it was changed.

Q. When?

A. Along about in 1938; I think somewhere in there.

Q. What change took place at that time?

A. Well, we paid off the two hundred thousand dollars.

Q. Were you still a stockholder at that time?

A. Yes, I was a stockholder at that time.

Q. Did you get the money?

A. I got my money, yes.

Q. In hand? A. The same thing, yes.

Q. You say "the same thing." How did you get it?

(Deposition of John McPherson.)

Mr. Butler: He has already covered it on direct examination.

Mr. Payne: I am going to ask it again.

A. I got it by delivering them—just giving me a credit; I didn't get the money, but giving me a credit on the regular account for it.

Q. So you never drew anything out?

A. No, I never drew it out.

Q. It was just a bookkeeping conversion?

A. It was at my request, yes.

Q. Did all the rest do the same thing?

A. I don't know whether they did or not. I don't remember. [32]

Q. You didn't lose any of the interest on your share of the \$200,000, did you?

A. No, I don't think so. We did the first year. (Pause.) No, no, I wouldn't lose any interest. I don't think we did.

Q. You say the change was made in 1938 or 1939? A. Yes, at the end of the year.

Q. Was that made by a bookkeeping entry?

A. Yes, I think so.

Q. And under the arrangement you had you continued to draw interest on the proportionate interest you had as represented by the two hundred thousand dollars?

A. Yes, I guess so. It was deposited back in, and we received interest, of course.

Q. Did you receive a note with respect to the deposit back?

A. Let's see. I don't remember. (Pause.)

(Deposition of John McPherson.)

Mr. Butler: Clarify the year.

Mr. Payne: He is the witness; I am not.

A. (Resuming) I don't remember whether we did at that time or not. I can't remember; but we received notes later on for it.

Q. That is what I want to know. Why did you leave it in,—your portion of it?

A. To get interest on it.

Q. Couldn't you get interest some place else?

Mr. Butler: That is immaterial and objected to.

Mr. Payne: This is cross examination, and [33] I reserve the right to ask him. He was the president.

A. I suppose so.

Q. Would the bank pay that kind of interest?

A. No.

Q. What kind of interest would the bank pay?

A. At that time we weren't paying anything. We pay three per cent, but we weren't paying interest on deposits at all at that time. We didn't accept savings accounts.

Q. Mr. McPherson, Mr. Butler asked you, and and you gave some testimony about the ratio of the stock and the "special account." Do you remember that? A. Yes, I do.

Q. And then he asked you specifically about the \$200,000, and asked you if it was at the risk of the business, and you said no.

A. It wasn't at the risk of the business.

Q. Where was the \$200,000 put by the corporation, do you know?

(Deposition of John McPherson.)

A. I just told you it was put in there in order to take it out of the bank,—to get it out of the bank.

Q. Did you just put it in the vault and leave it there? A. No. [34]

Q. What did you do with it?

A. We invested it.

Q. In what?

A. We turned over notes at that time, and different things, to the company, and overloans. We turned it over to them so that we could get earnings from them.

Q. You don't know what kind of loans it was invested in?

A. Most of the time when we first started it would be all notes and mortgages. We didn't have any farm lands at that time,—when we organized the company. We took those farm lands afterwards,—made investments in farm lands afterwards.

Q. Suppose those notes that Wilbur Security took were worthless—became worthless——

A. They weren't worthless, of course. They were paid.

Q. ——would you say, then, that the investment was at the risk of business operations?

A. No, it wasn't at the risk of business operations.

Q. It wasn't? A. No.

Q. You mean money out on notes which Wilbur took? A. Yes.

(Deposition of John McPherson.)

Q. Suppose Wilbur couldn't make collection of notes?

A. Suppose Wilbur Security couldn't collect their notes?

Q. Yes. [35]

A. They would lose their money.

Q. What would there be to pay the two hundred thousand dollars with?

A. What would there be to pay the two hundred thousand dollars with?

Q. Yes.

A. Well, I don't suppose we could, if the assets of the company were no good. We couldn't pay it if the assets were no good.

Q. So the two hundred thousand dollars was protected, of course, on whether—

A. —whether the assets of the company was worth it, but we figured they were a preferred account over and above the stock. The stock would be last.

Q. You testified on direct that in 1943 the "notes payable account" was represented by notes which were issued by Wilbur? A. Yes, that is right.

Q. You stated that those notes were renewed?

A. Yes.

Q. Do you know how that was accomplished?

A. By giving new notes.

Q. Each year?

A. Yes, practically each year.

Q. Why do you say "practically"? [36]

A. I think there was a year or two that we

(Deposition of John McPherson.)

just made the endorsement of interest on the back of the old note, and as far as that is concerned, when we paid the interest on them, that renewed them.

Q. You testified on direct about the consolidation of accounts in 1938, which was accomplished by the by-laws? A. Yes.

Q. What was your understanding of that?

A. We consolidated the accounts because there was no use having two accounts in the Security Company.

Q. What you mean is that the former "stockholders account," and the former "special account" were consolidated at that time?

A. Yes, practically so.

Q. And then you testified the new people were advised of that change?

Mr. Butler: I am going to ask counsel to clarify it. I don't think the witness understands.

A. I don't think we had any new people that I know of, outside of Mrs. Phillips. It was the same old stockholders, with the exception of Mrs. Phillips.

Q. You said they were advised of the change, or words to that effect. What did you mean?

A. They knew about the change.

Q. What do you mean by that? [37]

A. Well, they were advised of the change because most of them were represented at stockholders' meetings when we did it.

Q. First, what do you mean by the "change"?

(Deposition of John McPherson.)

A. We changed it,—you are talking about the change from one account to the other?

Q. The consolidation as reflected by the by-laws, according to your original testimony. What was the change?

A. We just consolidated the two accounts,—just moved them together. There was no use having two accounts. We took a note for the whole thing with a specific due date on it.

Q. You testified that you are no longer a stockholder in Wilbur? A. Yes, that is right.

Q. But that you have money on deposit with the company, \$197,000?

A. I have a note for that, yes.

Q. Is that an annual note?

A. No, the note is due in two years.

Q. When did that begin?

A. Last December.

Q. So we are talking about a time subsequent to the taxable years we have under consideration in this proceeding?

A. I took that note last December. [38]

Q. When you say “last December,” that note was given you in December, 1956?

A. Yes, December, 1956.

Q. Were you an officer and stockholder up through 1955? A. Yes.

Q. When did you cease to be an officer and stockholder?

A. In January of 1957. Really, in December,

(Deposition of John McPherson.)

1956, as far as that is concerned. I sold out and resigned.

Q. Now, Mr. McPherson, Wilbur has for a long period of years had the so-called outstanding accounts, or "notes payable account"?

A. Yes.

Q. Or bills payable accounts. They are referred to in different terminology. Is it true that Wilbur has not always paid interest on those?

A. Yes, during the depression we didn't have earnings, and we didn't pay interest, no.

Q. The people who had made those advances were pretty close to the officers of the corporation, weren't they?

A. Oh, yes.

Q. And the officers of the corporation knew better than anyone what the standing of the company was, and what the business expenses or losses were?

A. Yes.

Q. Have you been an officer of the Wilbur State Bank during [39] the same period of years that you have been an officer of Wilbur Security?

A. Yes, I have. Well, I was officer of the bank before we formed the Security Company.

Q. Now, as an officer of Wilbur you realized that you had a very large amount of so-called borrowed money over a long period of years?

Mr. Butler: I object to the form of the question. It assumes a premise that is not called for.

Q. You testified that the borrowing had been up around \$500,000 over a period of years, is that correct?

(Deposition of John McPherson.)

A. Yes; in some years it was more than that.

Q. You are perfectly familiar with that, aren't you?

A. Yes.

Q. And as an officer of the corporation?

A. Yes, I was familiar with that.

Q. You know it of your own knowledge without resort to any papers or records? You remember that? The answer is "yes"?

A. I was familiar, yes.

Q. You haven't always paid the same rate of interest on those borrowings, have you?

A. No.

Q. Why?

A. Well, it would depend on the demand for money. [40]

Q. Who determined that?

A. The note holders,—whether they were going to let us have it for more or for the same interest rates.

Q. Didn't the officers of the corporation determine that from year to year?

A. They determined whether they would pay it or not, yes.

Q. You are in the banking business and are familiar with business operations and the value of securities and different types of securities. Did Wilbur ever attempt to borrow the money it needed in its operations from some other sources?

A. Yes, we have borrowed money from some other sources, quite a little, at different times.

Q. Did you ever attempt to borrow the money

(Deposition of John McPherson.)

to replace the half million dollars which you borrowed from the stockholders and members of families of stockholders? A. Yes, we did.

Q. When?

A. In 1956 or 1955,—I forget which; but one of those years.

Q. How about the year 1953? Did you make any attempt to borrow the money?

A. No. We were offered the money to pay them all off.

Q. By whom? A. By a bank. [41]

Q. What bank?

A. The National Bank of Commerce at Seattle.

Q. When?

A. It was in 1956—I think it was in 1956.

Q. At what rate of interest?

A. Four and three-quarters; I forget, but some per cent like that.

Q. What was the decision of Wilbur Security?

A. Well, we decided that we wouldn't take it, but let it run the way it was at 5 per cent for two years. They wouldn't agree to let us have it except from year to year; so we got it for two years, and now we are carrying it at 5 per cent, the way it was, on a two-year note. We felt that that was better for us than not to know we could renew it. We didn't know how business would be. So we thought we had better pay a little more interest and have that privilege. They wouldn't give it for two years. They said interest rates fluctuated, and they didn't know if they wanted it for two years.

(Deposition of John McPherson.)

Q. I believe it is true, is it not, that the amount of money advanced to Wilbur over the period of years we are talking about was by either the stockholders in Wilbur, or by members of the immediate families of stockholders?

A. No, I don't think so. [42]

Q. Do you know of any variation?

A. I think there was.

Q. Can you identify it as to the year and name?

A. No, I can't, unless I had access to the books.

Mr. Payne: That is all.

Redirect Examination

Q. (By Mr. Butler): Did you have any controversy with regard to the valuation of the stock in the Wilbur Security with the Internal Revenue Service at the time your wife died?

A. Yes, I did.

Q. What did you eventually value the stock at? First, when did she die?

A. We had a controversy with them in regard to the valuation.

Q. What year was that?

A. 1953, I think.

Q. Now, what did you value the stock at?

A. \$2300 a share.

Q. That was the amount agreed upon?

A. What?

Q. That was the amount agreed upon with the Revenue agents?

(Deposition of John McPherson.)

A. Yes, \$2300 a share. That is what we settled with them on. [43]

Q. Now, Mr. Payne showed you some income tax returns of Wilbur for the year 1953, and he showed you a balance sheet which indicated a number of farms, and at the bottom it showed a value of \$453,000, or whatever the value was. Did you testify that that value was the amount that you paid for the farms?

A. Yes, what we carried them on the books—what we took them in at.

Q. Have you had quite a bit to do with the real estate valuations over the years as a banker?

A. Yes.

Q. Are you familiar with real estate values in Wilbur, in and around Wilbur, and particularly farm lands? A. Yes.

Q. What in your opinion is the fair market value, or would have been the fair market value of those farms in 1953, 1954 and 1955?

Mr. Payne: I object to that without identifying the farms, their location, their nature, the acreage and related matters. To just ask generally whether he knows without knowing which farms we are talking about is certainly objectionable.

Mr. Butler: I am speaking about the farms owned during the years 1953, 1954 and 1955,—all of the farms owned by the Wilbur Security Company. [44]

Q. What in your opinion would be the fair market value of those properties?

(Deposition of John McPherson.)

Mr. Payne: I object again.

Q. Go ahead and answer?

A. I think something over a million dollars.

Q. How much over a million dollars?

A. Probably a million two hundred thousand.

Q. Now, we were talking, both myself on direct and Mr. Payne on cross examination, about this resolution that was adopted in 1915 or 1916 that said in effect that when you transferred a share of stock you also had to transfer a part of the stockholder account. Do you remember the resolution?

A. Yes.

Q. Was that adhered to after 1938?

A. No, it wasn't in existence after that.

Q. Wilbur Security Company borrowed money from people who were not stockholders of the corporation, is that correct?

A. Yes.

Q. And did those people have any part in the management of the corporation?

A. Not a bit; nothing to say about it.

Q. Now, you stated in cross examination that the note holders determined whether the interest was to be paid, [45] and then later you said whether interest would be paid was determined by the officers of Wilbur Security. Who in effect determined whether interest would be paid?

A. I don't know what you mean.

Q. Well, did the corporate officers or the note holders?

A. Yes, we determined whether we would pay interest,——

(Deposition of John McPherson.)

Q. Who is "we"?

A. —and what rate we wished to pay.

Q. Who is "we"?

A. The company,—the officers of the company.

Q. Now, as a note holder in the Wilbur Security—when I saw "note holder," I have in mind either in the "stockholder account" during these years, the "special account," or the note account,—during the depression years, if you had taken your money out of the Wilbur Security Company, could you have loaned that money to somebody else at the same interest rate?

Mr. Payne: Objected to as calling for a conclusion and not for a fact.

A. Yes, obviously.

Q. Could you have loaned it with the same security behind the loan as you had at the Wilbur Security Company?

A. Well, I don't think so; I don't know. No, I don't think we could have. We had a lot of assets in the company. [46]

Mr. Butler: I have no further questions.

Mr. Payne: No further questions.

/s/ JOHN McPHERSON. [47]

Certificate of Return of Deposition Attached.

[Endorsed]: Filed December 26, 1957.

[Endorsed]: No. 16496. United States Court of Appeals for the Ninth Circuit. Wilbur Security Company, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Petition to Review a Decision of The Tax Court of the United States.

Filed: June 4, 1959.

Docketed: June 10, 1959.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for
the Ninth Circuit.

In the United States Court of Appeals
for the Ninth Circuit

No. 16496

WILBUR SECURITY COMPANY,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

STATEMENT OF POINTS RELIED UPON

Comes now the Petitioner and asserts the following errors which it urges on Review by the United States Court of Appeals for the Ninth Circuit of the decision of the Tax Court of the United States Court reported 31 T. C. No. 92.

1. That the Tax Court erred in holding that the amounts which petitioner had outstanding in its

bills payable account during each of the taxable years 1953, 1954 and 1955 were equity invested capital rather than loans.

2. That the Tax Court erred in holding that the payments made by the petitioner on the amounts outstanding in its bills payable account for each of the taxable years 1953, 1954 and 1955 were dividends and not interest payments, deductible as such for Federal Income Tax purposes, in computing its corporate income tax for such taxable years.

3. That the Tax Court erred in failing to find that the amounts outstanding in petitioner's bills payable account during each of the taxable years 1953, 1954 and 1955 represented a loan to the petitioner and that the payments made by the petitioner in each of the taxable years were interest payments fully deductible in arriving at taxable income for the said taxable years.

4. That the Tax Court erred in failing to include in their Findings of Fact material matters which transpired before and after the taxable years involved in this controversy which should have been considered in determining whether the amounts outstanding in the bills payable account represented loans or equity invested capital during the taxable years 1953, 1954 and 1955.

CASTOLDI & BUTLER,
/s/ By FRANCIS J. BUTLER,
Counsel for Petitioner.

Certificate of Service Attached.

[Endorsed]: Filed July 8, 1959. Paul P. O'Brien,
Clerk.

[Title of Court of Appeals and Cause.]

DESIGNATION OF CONTENTS OF RECORD ON REVIEW

Comes now the Petitioner by and through its attorneys and designates the following portions of the record to be printed on review of the above entitled case from the Tax Court of the United States to the United States Court of Appeals for the Ninth Circuit:

1. Tax Court Petition.
2. Tax Court Answer.
3. Official Transcript of the Proceedings before the Tax Court.
4. Stipulation of Facts, without joint exhibits attached.
5. Deposition of Grace Lewis Phillips and John McPherson, dated November 8, 1957.
6. Supplemental stipulation of Facts without exhibits attached.
7. Findings of Fact and Opinion of Tax Court.
8. Order dated February 4, 1959 Amending Opinion.
9. Decision of the Tax Court.
10. Petition for Review with Proof of Service attached thereon.
11. Statement of Points Relied Upon.

12. Designation of Contents of Record on Review.

/s/ FRANCIS J. BUTLER,
Counsel for Petitioner.

Certificate of Service Attached.

[Endorsed]: Filed July 8, 1959. Paul P. O'Brien,
Clerk.

[Title of Court of Appeals and Cause.]

STIPULATION

Comes now the party, by and through its respective counsel, and stipulates that the exhibits entered in the above entitled proceeding, except the exhibit received in evidence which contains the deposition upon oral examination of Grace Lewis Phillips, and John McPherson, may be considered in their original form for the purpose of this appeal and that therefore the exhibits need not be produced in the printed record.

/s/ PAUL CASTOLDI,
/s/ FRANCIS J. BUTLER,
Counsel for Petitioner.

/s/ CHARLES K. RICE,
Assistant Attorney-General, Department of Justice,
Counsel for Respondent.

[Endorsed]: Filed July 18, 1959. Paul P. O'Brien, Clerk.

United States Court of Appeals

For the Ninth Circuit

WILBUR SECURITY COMPANY

Petitioner,

vs.

COMMISSIONER OF INTERNAL
REVENUE

Respondent.

No. 16496

BRIEF FOR PETITIONERS

*Appeal from the Tax Court of the
United States*

FILE

DEC 14 1935

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United States Court of Appeals

For the Ninth Circuit

WILBUR SECURITY COMPANY

Petitioner,

vs.

COMMISSIONER OF INTERNAL
REVENUE

Respondent.

No. 16496

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<i>Tauber, Sheldon</i> (1955) 24 T.C. 179	14
<i>Wilbur Security Company</i> (1959) 31 T.C. No. 92	6

STATUTES

*Internal Revenue Code of 1939 Section 23(b)**Internal Revenue Code of 1954 Section 163*

INDEX OF EXHIBITS

Exhibit Number	Identified	Offered in Evidence	Rejected
<i>Joint Exhibits</i>			
1-AA to 43QQ	71	73	
23 WW	120	121	
45-RR to 47-TT	26	26	
<i>Petitioners' Exhibits</i>			
44	116	117	
Deposition (No number)	73	83	

JURISDICTIONAL STATEMENT

The Tax Court of the United States, in a written opinion (31 T. C. No. 92) held adversely to Petitioners herein under date of January 30, 1959. The decision was amended February 4, 1959. The decision of the Tax Court called for a rule 50 computation and the final decision was entered March 13, 1959.

Petitioner filed a Petition for Review with the United States Court of Appeals for the Ninth Circuit on or about the 21st day of April, 1959, together with a Statement of Points Relied Upon and a Designation of the Record on Review. A Notice of Filing Petition for Review, together with a copy of Petition for Review, a copy of Designation of Contents of the Record on Review, and a copy of the Statement of Points Relied Upon were served upon the chief counsel, Internal Revenue Service, in Washington D.C. on April 21st, 1959.

The income tax returns for the periods here involved were all filed with the District Director of Internal Revenue for the State of Washington at Tacoma, Washington.

This court has jurisdiction on appeal from the decision of the Tax Court of the United States by virtue of Section 7482 of the Internal Revenue Code of 1954.

STATEMENT OF THE CASE

The Wilbur Security Company (hereinafter referred to as either the petitioner or the corporation) is a Washington corporation which has operated in the state of Washington

since March 18, 1915. During the taxable year 1953, 1954, and 1955 petitioner had the following amounts outstanding in its Bills Payable Account upon which interest was paid:

Year	Amount Outstanding	Interest Paid
1953	\$552,518.40	\$32,311.10
1954	552,518.40	33,151.10
1955	552,518.40	33,151.10

The interest above was taken as a deduction by the corporation on the Federal Income Tax Returns as filed for each of the said taxable years. It is this interest deduction that is here in the controversy. The respondent by a statutory notice of deficiency, disallowed the interest taken by the plaintiff on the theory that the interest expenses did not constitute interest on indebtedness (T. 9). The problem is whether the advances constitute bona fide indebtedness of the petitioner or whether in reality, such amounts constitute equity invested capital (T. 27).

Although the well worn cliché “Inadequate Capitalization” was not used by the Tax Court in arriving at their decision, the cases relied upon by the Tax Court all involve the inadequate capitalization field. The Tax Court in deciding the question found that the advances by certain individuals to the plaintiff were additional contributions to capital and that interest payments were dividends and therefore not deductible by petitioner for Federal Income Tax purposes. This decision resulted in income tax deficiencies to the petitioner for the taxable years 1953, 1954, and 1955 totaling \$48,028.81.

The petitioner was organized in March 1915 at a time when the Federal Income Tax was an infant some 18 months old. The initial capital of the corporation was \$25,000. This amount was paid in 1916. At the time of the organization of the corporation, the stockholders deposited with the petitioner \$200,000 which amount was held in a special account known as "Special Stockholders Account". In 1915 the by-laws of the corporation provided that the amounts outstanding in the Special Stockholders Account would be transferred in proportion to the stock if any of the stock was sold. The \$200,000 in the Special Stockholders Account was characterized by the parties as loans and was withdrawn from time to time (T. 152, 177). The said amount was at the risk of the business and was from time to time withdrawn (T. 154). Certainly the corporation had no thought of income taxes in 1915 and would not have needed more than \$25,000 to run the business when it was formed (T. 152).

From 1915 to 1938 the corporation borrowed amounts from stockholders and from others. In 1938 the corporation had borrowings of \$356,230.55 over and above the \$200,000 which had been held during these years in the Special Stockholders Account. The additional borrowings were from stockholders and others who owned no stock in petitioner and the account on the petitions books was labeled, "Special Account". (T. 17, Exs. 9-I and 18-R).

In June of 1939 the Special Stockholders Account of \$200,000 was paid off in full. The amounts which the petitioner had borrowed from others and the amount in the

Special Stockholders Account were consolidated into what was known on the books of the petitioner as "Special Account". The \$200,000 was paid off through book entries at the request of the individual stockholders involved (T. 175).

The "Special Account" remained on the books of the corporation until 1942. In 1942 the amount of borrowing outstanding from the corporation was \$549,518.40 of which approximately 50 per cent were amounts borrowed from persons who owned no stock interest in the corporation (T. 18, Exhibit 12-L).

In 1943, pursuant to a resolution of the board of trustees of the petitioner, the "Special Account" payable was changed on the books of the petitioner to "Bills Payable". Notes with a one year maturity date bearing interest at the rate of 5 per cent per annum were set up on the books of the corporation (T. 19, Exhibits 13-M, 14-N). Book entries of the corporation evidenced this change in nomenclature of the account (T. 118 and 119).

This account i.e. "Bills Payable" account, remained on the books of the petitioner until 1957 when it was changed in name only to "Notes Payable Account" by the then accountant for the corporation who deemed the usage of the words Bills Payable to be old fashioned and not in accordance with modern day accounting principles (T. 118).

It was the amount outstanding in the "Bills Payable Account" upon which the interest payments were made and which generated the present controversy. The following schedule shows the persons who were either stockholders

or noteholders in the petitioner during the taxable years 1953, 1954, 1955, and the percentage of stock and notes owned.

SCHEDULE

Stockholder	1953		1954		1955	
	Notes	Stock	Notes	Stock	Notes	Stock
Sarah Farnsworth	11.55%	36%	11.55%	36%	0	0
Grace Phillips	15.08%	0	15.08%	0	26.62%*	36%
Catherine Bernhard	4.52%	0	4.52%	0	4.52%	0
Elizabeth McPherson	.72%	2%	.72%	2%	.72%	2%
J. McPherson	26.06%	41%	26.06%	41%	26.06%	41%
J. K. McPherson	4.34%	10%	4.34%	10%	4.34%	10%
Kate McPherson	15.75%	0	15.75%	0	15.75%	0
E. H. Oswalt	1.09%	3%	1.09%	3%	1.09%	3%
G. Thompson	2.90%	8%	2.90%	8%	2.90%	8%
Julia McPherson	17.99%	0	17.99%	0	17.99%	0

*Grace Phillips acquired her stock in the petitioner August 17, 1955.

As seen from the above schedule the ratio of percentages in the stock and note account are not proportionate. In fact during 1953, 1954 and most of 1955 over 50 per cent of the advances outstanding in the Bills Payable Account were from individuals who owned no stock interest in the petitioner. In addition to this, those who did own stock in the corporation did not own notes in proportion to their stock holdings. In no instance was the amount held proportionately.

During each of the taxable years 1953, 1954, and 1955 there were notes outstanding covering the amounts in the Bills Payable Account. The notes in these years were one year notes with a provision for interest and were renewed

each year either by issuing a new note or renewing the old note.

During 1953, 1954, and 1955 petitioner had assets with a fair market value of at least \$1,600,000, and surplus of over \$150,000. The petitioner could have borrowed the money outstanding in the Bills Payable Account from other sources. The noteholders were not subordinate to other creditors although on one occasion they were requested to subordinate their loans and refused to do so. The noteholders intended the amounts in the Bills Payable Account to be loans and did not consider that the amounts were at the risk of the business. The noteholders who owned no stock in the petitioner did not share in the management of the petitioner nor in the profits of the petitioner.

The Internal Revenue Service upon investigation of the petitioner determined that the interest payments to the stockholders and non-stockholders alike were a disallowable deductions for federal income tax purposes. This position was a restatement of a position taken many years prior to the taxable years involved herein. The Internal Revenue Service had taken the same position in 1937 and 1938 but dropped the contention after conference with the taxpayers.

The Tax Court of the United States in its opinion (T. 50), agreed with the position taken by the Internal Revenue Service and stated as follows:

“Looking only to the facts of the years in question, without regard to the circumstances of prior years, the Bills Payable Account might appear to be bona fide indebtedness. For each account, there existed a note,

bearing a stated rate of interest, and payable at a fixed maturity date, one year from the date of making the note. The ownership of the stock did not continue in the same proportion to the interest in the bills payable account. Some persons owning interests in the Bills Payable Account did not own any stock, nor did they have any right to vote or participate in the management. The names on the certificates, Bills Payable, suggest an indebtedness rather than capital investment. Finally, the declared intent of the petitioner as set out in the minutes of the Directors Meeting would suggest the existence of an indebtedness. However, we are satisfied that to accord determinative weight to these apparent indicia of an indebtedness without consideration of the events and circumstances of prior years, where material, would distort the true facts and obscure the reality of the arrangement here involved."

The Tax Court of the United States, as can be seen from the above quotation, felt that if the years in question were important the indicia of bona fide indebtedness as set out in the stated cases was apparent but that in this particular case ancient history was far more determinative of the intent of the parties than the years in question.

Based upon substantive case law of the United States Court of Appeals for the Ninth Circuit and the facts of this case the Tax Court clearly erred.

SPECIFICATIONS OF ERROR

I.

The Tax Court of the United States erred in holding that the amounts which petitioner had outstanding in its Bills Payable Account during each of the taxable years 1953, 1954, and 1955 represented equity invested capital rather

than loans and that the interest payments made by petitioner thereon during each of the said taxable years were not deductible in arriving at taxable income.

ARGUMENT

The Tax Court Erred in holding that the amounts outstanding in the Bills Payable Account of the Petitioner for the taxable years 1953, 1954, and 1955 represented equity invested capital and not loans.

In the instant case the petitioners had advances outstanding in the total amount of \$552,518.40 during the taxable years 1953, 1954, and 1955. The Internal Revenue Service disallowed as deductions for tax purposes the interest payments on these notes during said years on the theory that the indebtedness represented equity capital and not loans. The Tax Court of the United States agreed with this holding (T. 26). The Tax Court decision, for the reasons set forth below, goes further than any other Court holding in the so-called inadequate capitalization field.

In so holding the Tax Court said:

“Looking only to the facts of the years in question, without regard to the circumstances of prior years, the Bills Payable Account might appear to be bona fide indebtedness. For each account, there existed a note, bearing the state’s rate of interest, and payable at a fixed maturity date, one year from date of making the note. The ownership of the stock did not continue in the same proportion to the interest in the Bills Payable Account. Some persons owning interest in the Bills Payable Account did not own any stock, nor did they have any right to vote or participate in the management. The names on the certificates, Bills Payable,

suggest an indebtedness rather than capital investment. Finally, the declared intent of the petitioner as set out in the minutes of the Directors Meeting would suggest the existence of an indebtedness. However, we are satisfied that to accord determinative weight to these apparent indicia of an indebtedness without consideration of the events and circumstances of prior years, where material, would distort the true facts and obscure the reality of the arrangement here involved." (T. 50).

The Tax Court forgot to add that over 50 per cent of the amounts outstanding in the Loan Account during the years here involved were from individuals who had no right to vote, no voice in management, and did not share in corporate profits. The fact that these people were related to the stockholders should cast no shadow on the declared intent. The Petitioner knows of no family attrition rules which would apply in the so-called inadequate capitalization field.

The events and circumstances of prior years which the Tax Court decided should be accorded great weight hark back to the very birth of the Federal Income Tax Law. The corporation involved herein was formed in 1915 at a time when the federal income tax was a mere infant preparing to celebrate its second birthday.

The Tax Court in relying upon ancient history and disregarding facts that are apparent in the taxable years have placed a fence around corporation loans. If the Tax Court holding herein (i.e. that in determining the character of advances for tax purposes you looked to the circumstances surrounding the creation of the corporation and disregard reality in the years in question), is sustained it will mean that

every corporation advance is cast at the beginning. Later events will be entirely immaterial. Stated another way, can a corporation thin at the outset ever gain weight?

The question of whether amounts advanced to a corporation constitute equity capital or indebtedness is a question of fact. The whole concept had its birth in some very unfortunate dicta in *Commissioner v. John Kelley Co.* (1946) 326 US 521. It would seem that people should be allowed to cast advances to a corporation in any manner that they seem fit. In this age of the tail wagging the dog for tax purposes such is not the case. This Circuit Court of Appeals in *Estate of Herbert B. Miller v. Commissioner* (CA, 9-1956) 239 Fed (2d) 729 reversing 24 T.C. 923, commented as follows:

“We know of no rule which permits the commissioner to dictate what portion of the corporation’s operations shall be provided for by equity financing rather than debt.”

The above quotation is true in cases where corporations were formed and planned with tax consequences in mind. It should also be true, in the instant case, where the corporation was formed 30 years prior to the unfortunate dicta in the *Kelley* Case referred to above.

The tests used by the Courts in determining the question involved herein are well set forth in the Tax Court opinion (T. 49) wherein the court set out 10 separate determining factors: 1. The name given to the certificates evidencing the indebtedness. 2. The presence or absence of a maturity date. 3. The source of the payments. 4. The right to enforce

the payment of principal and interest. 5. Participation in management. 6. A status equal to or inferior to that of regular corporate creditors. 7. The intent of the parties. 8. Capitalization. 9. Identity of interest between creditor and stockholder. 10. Payments of interest only out of dividends.

In addition to the above ten factors set forth by the Tax Court, the Courts have also looked to whether or not the corporation could have obtained loans from outside lending institutions, See *E. Erard A. Matthiessen* (1951) 16 T.C. 786 affirmed (CA-2, 1952) 194 Fed (2d) 659.

The best way to approach the tests, referred to as important factors by the Tax Court set forth above, is to compare each test with the facts in the instant case.

There is no question that Notes evidencing the indebtedness were issued in the instant case and the notes had none of the indicia of equity ownership. (Test No. 1, above). The notes had fixed maturity dates and interest was paid. (Test No. 2, above). The notes in all the years in question were either reissued or renewed. The Tax Court in its opinion has found no quarrel with this contention (T. 50).

Test No. 3, above, concerns the source of the payment. If this means the source of the original loan the amounts in the Bills Payable Account in the years in question were not from earnings. The 1915 advances were paid off in 1938. The corporation had earnings in each of the taxable years and paid, in addition to the interest, dividends and salaries. Over 50 per cent of the interest was paid to non-stockholders who received no dividends since they did not share in

the corporate profits. In this regard what this Court said in the *Miller* case *supra* seems appropriate.

“It is true that it was contemplated that the notes would be paid out of the earnings of the corporation, but the most excellent record of the past earnings of this same business was such that this was the reasonable contemplation. Many borrowers rely upon expected earnings for payments of their debts. We cannot see any justification for inferring that a promissory note is unreal and not representative of the actual arrangement merely because the maker expects to pay out of future earnings.”

The right to enforce the payment of principal and interest is the next factor eluded to by the Tax Court (Test No. 4, above). As applied here the principal amount of the debt was in three instances completely paid off subsequent to the taxable years involved herein. J. K. McPherson's notes were paid off in 1957 although he remained a stockholder (T. 89). In addition to J. K. McPherson, G. Thompson and Mr. Oswald withdrew the amounts which they had outstanding in the Bills Payable Account, although both were stockholders (T. 161-162). The facts concerning the above withdrawals, although clearly a part of the record were not included in the Tax Court findings. Grace Phillips withdrew amounts from the Bills Payable Account. On one occasion the withdrawal was \$14,000 and in another instance the withdrawal was \$69,000 (Transcript p. 45).

It has been previously stated for 1953, 1954, and most of 1955 over 50 per cent of the amounts outstanding in the Bills Payable Account were from individuals who owned no stock interest in the petitioner. These individuals had no

voice in management (Test No. 5, above). The Tax Court in its opinion recognized that the non-stockholders had no right to vote or participate in corporate management (T. 50). The non-stockholder did not participate in the fluctuation of the stock value that took place over the years and intended the Bills Payable amount as loans specifically not at the risk of the business (T. 94, 167).

In the instant case the amounts in the Bills Payable Account were not subordinate to other corporate creditors (Test No. 6, above). On one occasion the non-stockholders of the corporation were requested to subordinate their indebtedness to other creditors and refused to do so (T. 159 and 89).

The individual certainly intended the Bills Payable to be loans (Test No. 7, above). There is no evidence in the record contra to this conclusion (T. 129, 160).

The next test spoken of, above (Test No. 8), is capitalization. In its opinion the Tax Court in determining ratios used 1915 figures disregarding the fact that in the taxable years involved the corporate assets surplus and paid in capital completely outweigh the debt (T. 51). The Tax Court ratio relied upon in 1915 is 8 to 1. The real ratio is about 5 to 1 in reverse i.e. the corporation in the taxable years had indebtedness of approximately \$552,000 but assets of over \$1,600,000.

The case law in the inadequate capitalization field substantiates the fact that real values must be used in computing ratios and that the values must be determined for

the years involved e.g. 1953, 1954, 1955 here rather than 1915.

In *Sheldon Tauber*, (1955) 24 T.C. 179 the Tax Court stated as follows:

“Thus, the initial capital of the corporation was not merely the \$100 of cash paid in by the four individuals and shown as capital in the books of the corporation, but was a much larger amount not shown on its books which was nevertheless available as working capital. The total capital of new corporation could not fairly be called ‘thin’.”

In *B. M. C. Manufacturing Corporation*, T. C. Memo opinion, Docket No. 31588 entered April 16, 1952, 11 T.C.M. 376 the Tax Court said:

“As to the capitalization, respondent draws no distinction between the petitioner’s condition at the time of the issuance of the two sets of debentures. Looking at the facts as of the date of the second issue, the contention is clearly unsupportable. By that time there was at the risk of the business and a part of petitioner’s capital structure some \$116,000 of accumulated earnings more than the entire \$100,000 of debentures issued at that time.”

In *Kraft Foods Company v. Commissioner* (CA-2, 1956) 232 Fed (2d) 118 reversing 21 T.C. 513 the Circuit Court of Appeals for the Second Circuit said:

“We think it obvious that in the determination of debt-equity ratios, real values rather than artificial par and book values should be applied.”

In *Estate of Herbert B. Miller* supra this Circuit Court of Appeal said:

“The Tax Court placed much emphasis upon what it called ‘an absurdly low capitalization’ of the corporation. While the Court expressly disclaimed any intent to decide whether inadequate capitalization in and of itself would authorize the court to disregard as genuine the purported indebtedness, it did discuss at length cases dealing with the so-called ‘thin’ capitalization question. The findings of the Tax Court referred to the declared value of \$1,050 set upon the organization of the Oregon Corporation.

“The finding, however, fails to note that the best available evidence upon the subject, namely, that furnished by the estate tax appraisal previously referred to, indicates that the declared value had no relation whatsoever to the real values of the corporate stock. When these facts are taken into consideration, it seems apparent that there was no disproportionate ratio of debt in capital in this case. If the capital stock was worth \$100,000, or thereabouts, as has been indicated, an indebtedness of \$174,000 would not be disproportionate, and no such ratio has ever been held to create a fatally thin capitalization.”

From the above cited cases, it can be seen that in computing the ratio of debt to equity realism is indeed a factor. Here the petitioner was not undercapitalized. Probably the best illustration that the petitioner had ample assets to cover the debt is the fair market value placed on the stock when Elizabeth McPherson died in 1953. The record shows that stock for estate tax purposes was valued by the Internal Revenue Service and the Estate of Elizabeth McPherson at \$2,300 a share. This means that the corporate assets (over and above debt) were at least \$575,000 (i.e. 250 shares @ \$2,300 a share).

Stock values on or about the crucial periods have been referred to in the decided cases and held material. For example, in the *Estate of Herbert B. Miller* supra, this court said:

“The general favorable earning capacity of the corporation and its business is indicated by the fact that in the estate of Herbert Miller his 100 shares of the capital stock of Miller Paint Company, Inc., were valued for estate tax purposes at \$347.78 per share; this as of February 13, 1948 approximately a year and a half after the transfer to the corporation.”

The petitioner herein was adequately capitalized at the time the instant loans were made. The *B.M.C. Manufacturing Corporation* case, supra, stands for the proposition that you must look the capital structure at the time the loan is made and not when the corporation is organized. See also *Earle v. W. J. Jones and Sons, Inc.* (CA-9, 1952) 200 Fed (2d) 846, affirming District Court of Oregon.

Identity of interest between creditor and stockholders i.e. pro rata holdings of stock and indebtedness, has always been an extremely important factor in the determination of whether an advance to a corporation represents equity capital or a loan. (See Test No. 9, above). This test has indeed been considered important. In *New England Lime Co.* (1949), 13 T.C. 799 the Tax Court allowed an interest deduction on certain debentures of the corporation and in so holding commented at length upon the favorable fact that stockholders did not hold the debentures in uniform proportion to their stock.

In *George L. Sogg* T.C. Memorandum opinion, Docket No. 23112 decided October 4, 1959 9 T.C.M. 924 affirmed (CA6-1952) 194 Fed (2d) 840, the petitioner was denied an interest deduction and the fact that the stockholdings and the loans were pro rata was deemed a material factor. In *B. M. C. Manufacturing Corporation* case, *supra*, the Tax Court in considering the question of adequate capitalization said:

“And finally perhaps most significantly, the interest was not distributed to the petitioners stockholders in anything like the proportions in which they held it stock. In fact the largest interest payment was made to a non-stockholder of petitioner, . . .”

Applied to the instant case this test (Test No. 9) leaves no doubt that the interest deductions taken by the petitioner were proper. When the non-pro rata aspect is considered with the fact that over half (50 per cent) of the amounts outstanding in the Bills Payable Account during the years have included were from individuals who owned no stock it would seem that the petitioners action in deducting interest payments was indeed proper. Certainly individuals who owned no stock, had no voice in the management of the corporation and did not share in the corporate appreciation or profits could not be considered stockholders. The testimony was to the effect that the stock increased and decreased in value. The amounts outstanding in the Bills Payable Account remained constant. The earnings of the Corporation had no bearing upon the interest payments during the years involved herein. The non-stockholders had no voice in the corporate affairs.

Payment of interest only out of dividends is the last factor spoken of by the Tax Court (Test No. 10, above). As applied to the instant case, the petitioner always paid substantial dividends. Naturally the amount of interest was paid from earnings. It would seem that this should not militate against a holding of debt as opposed to capital contribution.

When the instant facts are compared to the ten (10) important tests set forth in the Tax Court opinion it's hard to imagine how the Tax Court arrived at its decision. In every instance the facts of the case meet the tests favorably yet the Tax Court has found it necessary to completely overlook the facts as they existed in the years material hereto and seek out facts that are based principally on ancient history (i.e. 1915 to 1938) choosing in so travelling to ignore the change that took place within the petitioner in the interim.

The important fact that the Tax Court didn't mention in setting out the ten fateful factors above i.e. whether or not the corporation could have gained the advanced from outside sources, is also favorable to the petitioner. In the *Matthiessen* Case, *supra*, the Court said:

"The possibility is remote indeed that a disinterested lender of money would have made the initial unsecured loan of \$20,000 to Tiffany in order to provide that corporation with the working capital necessary to embark on a speculative building project. It would be even more improbable that such a lender would continue to advance funds for a venture such as Tiffany which was showing an increased deficit in each year."

The instant corporation could easily have borrowed money from outside sources. The National Bank of Com-

merce in Seattle, Washington offered to loan the corporation enough money to completely pay off the Bills Payable Account. Any lending institution would have gladly loaned the corporation enough money to pay the holders of the Bills Payable Account. The corporation had assets of over a million and a half dollars and no liabilities other than that outstanding in the Bills Payable Account. The chief appraiser for the Equitable Life Insurance Society of the United States testified that he would have recommended a loan in excess of \$500,000 to this corporation. This is substantial evidence the amount in the Bills Payable Account was a loan and not a contribution to capital.

The Tax Court in its opinion dwelt at length on ancient history (T. 50, 51). Much is made of the fact that in the earlier years (with regard only to the \$200,000 in the Special Stockholders Account) no notes were in evidence. Again the years 1915 and not the taxable year.

In 1939 the Special Stockholders Account was transferred to the Special Account. The tax court in its opinion states in effect that this lacks substance and therefore did not alter the identity of the account in any manner. The Tax Court said: (T. 52).

“However, aside from the resolution passed at a meeting of the Stockholders in 1939 there is no record of the amounts being distributed in fact to the interested parties, but there was merely an entry on the books whereby the Special Account was credited and the Special Stockholders Account was debited.”

The petitioner asks what other evidence could there be? Is it necessary in such a situation to withdraw money and reloan? The minutes stand on their own feet in this situation and fully set forth the intent of the parties (Ex. 10-J, 11-K).

The Tax Court speaks of the corporate resolution calling for \$800 in the Special Account for each share of stock. (T. 53). The record is quite plain that the resolution was not followed after the Special Stockholders Account became extinct in 1938. J. K. McPherson for example knew nothing of this article in the by-laws until the Internal Revenue Agent pointed it out to him in 1953 (T. 92).

The Tax Court's opinion states as follows (T. 53):

"In 1943, petitioner converted the Special Account to the Bills Payable Account at the advice of its accountant. For the first time notes were made reflecting the amounts in the account. These notes bore a stated rate of interest, and a maturity date of one year from the date they were made. However, these notes remain in the possession of the petitioner and no stockholder saw them although some knew of their existence. At the end of each year either the notes were marked paid by one of the petitioners officers and new notes issued for the same amount, or the old notes were simply renewed. These transactions were accomplished without the concurrence of those other than the stockholders, owning interest in the Bills Payable Account."

J. K. McPherson testified that the Board of Directors of the corporation requested that notes be renewed (T. 90, 91). The procedure for the renewal of the notes in 1953 was brought out quite clearly on cross examination (T. 100, 101, 102). The notes were renewed automatically but there were discussions leading up to the renewal of the notes (T.

103). Interest was paid by crediting the individual accounts of the stockholders and non-stockholders (T. 102).

As to the variation of interest rate referred to by the Tax Court in its opinion (T. 53), the witnesses stated the interest rate depended upon the demand for money and the interest rate was determined by the noteholders (T. 182). It is not known where the record supports the assertion that the notes were handled without the concurrence of those other than the stockholders owning interest in the Bills Payable Account.

It must be remembered that the over all amount outstanding in the Bills Payable Account upon which interest was paid in 1953, 1954, and 1955 was \$552,518.40. The majority of the Tax Court Opinion is concerned only with the original \$200,000. The excess i.e. \$352,518.40 of which most was owned by non-stockholders is not mentioned as such. The Tax Court states in distinguishing the non-stockholders (T. 55):

“Aside from the absence of voting rights and participation in management, there were no distinctions between the \$200,000 account and the Special Account.”

The only other difference that could be present under the circumstance would be that the noteholders, who owned no stock, did not participate in the income of the petitioner. The fact that they did not so participate is clearly a statement of fact supported by the record with no evidence to show otherwise. (T. 95, 161).

The Tax Court of the United States, in the instant case, has, contra to its previous views, completely overlooked the record as to intent of the parties. There is nothing in the said record which would overcome the assertion that the parties intended the amounts outstanding in the Bills Payable Account to be loans. The record clearly shows that the parties did so intend. (T. 87, 88, 129, 152). It would seem that the Tax Court is not free to disregard relevant uncontroverted evidence. In *Abraham J. Gordon et. al.* (CA-3, June 1959) reported at 59-2 U.S.T.C. §9551, rev'g Tax Court Memorandum decision 17 T.C.M. 842 the court said:

“ . . . , we think that the Tax Court arbitrarily disregarded unchallenged, competent and relevant evidence in the record which was inherently credible.”

In the instant case the Tax Court has disregarded all the evidence concerning intent and substituted in lieu thereof corporate transactions which are so far removed from the years in question as to be completely immaterial.

The noteholders of the petitioner all intended the amounts on deposit in the Bills Payable Account to be loans. The petitioner was not inadequately capitalized and none of the well worn criteria for determining “equity as opposed to debt” have been violated under the instant set of facts. Notes with a definite maturity date and calling for a fixed rate of interest were issued by appropriate corporate authority. The interest was paid throughout the years involved herein. The holders of the amounts in the Bills Payable Account refused to subordinate their loans to other credi-

tors. The noteholders and the stockholders were disproportionate and over one-half of the amounts in the Bills Payable Account represented advances from parties who had no stock interest in the corporation. The factors set forth in the decided cases, and specifically set out in the Tax Court opinion, indicate that the parties intended the amounts outstanding in the Bills Payable Account to be loans not at the risk of the business.

The Tax Court of the United States has taken, in the instant holding, one giant step further in making all advances to a corporation equity as opposed to loans. The holding is in error.

CONCLUSION

The Tax Court of the United States has erred in the instant case in their holding that the amounts outstanding in the petitioner's Bills Payable Account represented equity invested capital and not loans. The Tax Court opinion should therefore be reversed.

Respectfully submitted,

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**In the United States Court of Appeals
for the Ninth Circuit**

WILBUR SECURITY COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

**On Petition for Review of the Decision of the
Tax Court of the United States**

BRIEF FOR THE RESPONDENT

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The Tax Court's finding, that the amounts out- standing in the taxpayer's "Bills Payable Ac- count" constitute equity capital invested in its business and that payments made by the tax- payer to those who owned an interest in that account were non-deductible distributions of dividends, is fully supported by the record and not clearly erroneous	26
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**In the United States Court of Appeals
for the Ninth Circuit**

No. 16496

WILBUR SECURITY COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

**On Petition for Review of the Decision of the
Tax Court of the United States**

BRIEF FOR THE RESPONDENT

OPINION BELOW

The findings of fact and opinion, as amended, of the Tax Court (R. 26-57) are reported at 31 T.C. 938.

JURISDICTION

This petition for review (R. 58-63) involves deficiencies in federal income taxes for the calendar years 1953, 1954 and 1955, in the respective amounts of \$13,520.46, \$17,254.17, and \$17,254.18 (R. 57-58). A notice of deficiency was mailed to the taxpayer on June 7, 1957. (R. 3, 7.) On June 24, 1957, the taxpayer filed a petition for redetermination of

those deficiencies (R. 3-12) under the provisions of Section 6213(a) of the 1954 Code. The decision of the Tax Court was entered on March 13, 1959. (R. 57-58.) The case is brought to this Court by a petition for review filed by the taxpayer on April 24, 1959. (R. 58-63.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the Tax Court's finding, that amounts paid by the taxpayer on a "Bills Payable Account" constituted dividends and not deductible interest, is clearly erroneous.

This in turn depends upon whether there is support in the record for a finding that the amounts outstanding in the "Bills Payable Account" constitute equity capital invested in the taxpayer's business rather than indebtedness of the taxpayer within the meaning of 1939 Code Section 23(b) and 1954 Code Section 163(a).

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.¹

In computing net income there shall be allowed as deductions:

* * * *

¹ Section 163(a) of the Internal Revenue Code of 1954 (26 U.S.C. 1958 ed., Sec. 163), applicable to the taxable years 1954 and 1955 here involved, contains provisions substantially the same as those contained in Section 23(b) of the 1939 Code, and therefore is not included here.

(b) *Interest*.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

* * * *

(26 U.S.C. 1952 ed., Sec. 23.)

STATEMENT

The facts, some of which were stipulated, as found by the Tax Court (R. 27-48) may be summarized as follows:

The taxpayer, Wilbur Security Company, hereinafter sometimes referred to as the Company, is a Washington corporation with its principal office located in the city of Wilbur, Washington. (R. 27.)

In 1915, the city of Wilbur, Washington, a small community of less than 1,100 population, was serviced by a single bank, the Wilbur State Bank, hereinafter referred to as the Bank. The stockholders of the Bank had a large amount of money on deposit with the Bank. The stockholders considered that the existence of such large deposits might attract other banking concerns to the city of Wilbur. To forestall such competition from developing, the stockholders of the bank formed the Company on March 18, 1915. A further purpose of the formation of the Company was to provide an entity which would serve and hold such of the Bank's customers as required long-term

loans that the Bank, under existing restrictions, could not carry. (R. 28.)

As originally constituted, the Company's Articles of Incorporation provided in part as follows (R. 28-32) :

Article Two

The objects for which this corporation are formed are:

* * * *

3. To charge and collect interest upon money loaned, invested or otherwise handled by it, and to derive profit upon any and all transactions by it, and to collect any share of any profit, result or property involved in any contract or transaction relating to its business.

* * * *

5. In all ways in its own right, to purchase, acquire, manage, develop, operate, improve, change, exchange, mortgage, lease, pledge, hypothecate, sell and dispose or [sic] properties and interests of all kinds, whether real, personal or mixed and wheresoever situate.

6. To take, acquire, purchase, own, sell, lease, exchange, pledge, mortgage, hypothecate, grant, improve and otherwise deal in real estate, town-sites and divisions, lots or subdivisions thereof, and to issue evidences of interest, title, or right in any such property, either in its own right or its rights under contract.

* * * *

9. To borrow or raise money upon all bonds, warrants, debentures, investment certificates and other negotiable or transferable instruments, or otherwise, as directed by the board of trustees.

10. To lend money or other property on its own account and to receive notes, obligations and evidences therefor, and conveyances, hypothecations and pledges as security for its repayment or redelivery of the same.

* * * *

Article Three

The capital stock of this corporation shall be Twenty-five thousand (\$25,000.00) Dollars, divided into Two Hundred Fifty (250) shares of the par value of One hundred (\$100.00) dollars per share.

* * * *

Article Six

The number of trustees of this corporation shall be five and the names and residences of the first trustees who shall manage the affairs of the corporation until the 1st day of July 1915, are J. McPherson, E. L. Farnsworth, Chas. Hudkins, G. Thompson, and E. H. Oswalt, all of Wilbur, Lincoln County, state of Washington.

Article Seven

The capital stock of this corporation may be transferred without restriction to any person already a stockholder therein, but shall not be transferable to any person or party not a stockholder of this company without the affirmative vote, approving such transfer, of at least two-thirds of the capital stock of this company, at a regular or special stockholders' meeting called for that purpose. In case any stockholder desires to sell all or part of the stock held by him to a person not already a stockholder of this

company, he shall notify the secretary of this company in writing, stating the amount of stock he desires to sell and the price asked, and shall attach his stock certificate to such notice and give the name and address of the prospective purchaser, the secretary shall then notify all of the other stockholders of this company, and such stockholders shall have an option on said stock at the price asked for thirty days following such notice. If none of said stockholders shall exercise their right of option at or before the expiration of said thirty days, the secretary of this company shall call a stockholders meeting in the manner provided in the by-laws for the purpose of voting upon such prospective purchaser and in case he shall be elected to become a stockholder of this corporation, the president and secretary thereof shall endorse upon such certificate of stock, under the seal of this corporation, using the form given in Article Eight herein, the fact that such prospective purchaser, naming him, has been duly elected to become a stockholder of this company, and such certificate shall then be returned. In case such prospective purchaser shall not be elected as herein provided, then said certificate shall be returned without such endorsement.

Article Eight

On every certificate of stock issued by this company, the following provision shall be printed thereon, to wit:

According to Article VII of the Articles of Incorporation of this company and an agreement entered into between the holder of this certificate

and all the other stockholders of this company, this certificate is not transferable until the stockholders of this company have been given an option for thirty days for the purchase thereof and such option expired, nor can this certificate be transferred, except to the stockholders of this company, without the consent of at least two-thirds of the capital stock voted in this company, which consent shall be endorsed hereon and signed by the president and secretary of this corporation, naming the person to whom same may be transferred, and bearing the corporate seal.

The following individuals were the original incorporators of the Company and subscribers of the 250 shares of \$100 par value stock authorized by its Articles of Incorporation in the number of shares and amounts indicated:

<u>Subscriber</u>	<u>No. of Shares</u>	<u>Amount</u>
E. L. Farnsworth	120	\$12,000
John McPherson	105	10,500
Charles Hudkins	10	1,000
G. Thompson	10	1,000
E. H. Oswalt	5	500

None of this stock was actually paid for or issued at this time. The taxpayer's incorporators subscribed to its stock in proportion to their stock interests in the Bank. (R. 32.)

On April 5, 1915, the taxpayer's subscribers held a special meeting at which time they each advanced amounts of money to the taxpayer as "deposits" and adopted the following amendment to the by-laws regarding the aforesaid deposits (R. 32-33):

Amendment No. 1

Article XII

The Several stockholder of the Wilbur Security Company having this day deposited with the Company the following amounts;

E. L. Farnsworth	\$96,000.00	
J. McPherson	84,000.00	
Chas. Hudkins	8,000.00	
G. Thompson	8,000.00	
E. H. Oswalt	4,000.00	\$200,000.00

Which sums are to be credited to each Stockholders "Special Stockholders Account" on the books of the Company. These accounts not to be withdrawn by any of said stockholders except by consent of two-thirds of the Capital Stock voted in this Company at any regular or special stockholders meeting.

When any stockholder sells any of his stock it is understood that \$800.00 of his "Special Stockholders Account" shall be transferred with each share of stock sold and the proper officer shall make the transfer on the books of the Company at the time the stock is transferred.

This by-law has never been amended by the corporation. (R. 33.)

The \$200,000 advanced to the taxpayer on April 5, 1915, by its subscribers had been on open account in the Bank to the credit of each subscriber. Upon its advance to the taxpayer, this amount was immediately redeposited by it in the Bank. (R. 33.)

On December 28, 1916, the taxpayer's board of directors held a special meeting at which time it was decided to set aside \$25,000 of its earnings as paid-in

capital. At the same meeting, it was decided to issue stock certificates to the original subscribers thereof. (R. 33.) The minutes of the meeting were as follows (R. 33-34):

Special meeting of the Trustees of Wilbur Security Company held this day and called to order by J. McPherson President at 3:00 P.M. All directors present. The following resolution was offered and unanimously adopted;—

Whereas the earnings of this Company are in excess of Twenty five thousand dollars:

Therefore be it resolved that \$25,000 be set aside as the fully paid capital stock
 1st of this Company and that certificates
 Dividend. of stock be issued to the several stockholders as a stock dividend as follows:

E. L. Farnsworth	115 shares
J. McPherson	105 “
Chas. Hudkins	10 “
G. Thompson	10 “
E. H. Oswalt	5 “
M. E. Hay	5 “
<hr/>	
Total	250 “

Meeting adjourned.

From 1915 to 1938, the Special Stockholders' Account totaled \$200,000 in each year and the Paid-in Capital Account totaled \$25,000 in each year, representing 250 shares of \$100 par value stock, the only outstanding stock. However, the individual interests in those accounts fluctuated during the period 1915

to 1938 in accordance with the amount of stock each stockholder owned. (R. 34-35.)

In addition to the \$200,000 in the Special Stockholders' Account, the taxpayer received various additional sums from 1915 through 1938. These amounts were received from the original subscribers, from stockholders and from nonstockholders. In every case, however, such nonstockholders were members of the immediate families of stockholders. (R. 36.) The accumulation of these amounts and their source during the years 1915 to 1938 were as follows (R. 37):

Year	Farnsworth	Phillips	McPherson	McPherson	McPherson	McPherson
	\$	\$	\$	\$	\$	\$
1915	15,000.00					\$50,000.00
1916	25,000.00					50,000.00
1917	40,000.00		4,000.00			70,000.00*
1918	61,000.00	4,933.15	13,000.00	36,000.00		36,000.00
1919	95,000.00	6,568.98	25,000.00	28,500.00		23,900.00
1920	114,950.00	11,515.46	34,000.00	21,000.00		25,900.00
1921	108,000.00	13,835.16	58,000.00	34,581.12		63,500.00
1922	107,000.00	14,994.26	52,500.00	31,000.00		53,000.00
1923	110,000.00	21,224.56	61,000.00	35,000.00		58,500.00
1924	95,500.00	20,000.00	66,000.00	38,000.00		61,000.00
1925	89,000.00	20,000.00	69,000.00	43,000.00		64,000.00
1926	102,000.00	10,000.00	55,000.00	47,000.00		69,000.00
1927	98,000.00		55,000.00	50,500.00		69,000.00
1928	90,000.00		64,750.00	54,500.00		73,000.00
1929	90,000.00		66,000.00	57,500.00		75,000.00
1930	100,679.35		72,722.65	75,388.30		97,753.70
1931	104,000.00		72,700.00	74,700.00		98,100.00
1932	104,000.00		74,100.00	74,300.00		97,220.00
1933	103,800.00		72,950.00	74,200.00		96,970.00
1934	102,600.00		69,950.00	74,050.00		95,790.00
1935	100,944.05		66,000.00	74,050.00		95,390.00
1936	88,141.55	10,000.00	64,000.00	74,050.00		95,390.00
1937	87,890.55		64,200.00	78,050.00		96,390.00
1938	97,790.55		78,000.00	81,050.00		99,390.00

* Transferred to the following from estate:

J. McPherson	\$ 3,000.00
Kate McPherson	33,500.00
Julia McPherson	33,500.00

Non-stockholders did not participate in management or in voting for the taxpayer's officers. The \$200,000 in the Special Stockholders' Account, the \$25,000 in the Paid-in Capital Account, and the monies in the Special Account were invested in loans upon notes and mortgages, primarily upon real estate (farm properties), in which the Bank was unable to invest. When some of the obligors could not meet the payments on the notes and mortgages, the taxpayer acquired title to the properties which had been held as the security for the loans. The acquisition of these farm properties occurred during the years 1929 through 1933 and their combined book value was from \$437,039.41 to \$445,594.72, whereas the fair market value was estimated to be in excess of \$1,500,000 during the years in question. The operation of these properties constituted the taxpayer's principal source of income. (R. 38-39.)

The taxpayer's surplus, dividends, salaries, interest paid on obligations not in issue, and amounts paid on the Special Account and Special Stockholders' Account from 1915 through 1938 were as follows (R. 39):

Year	Surplus	Dividends	Salaries	Interest Paid on Obligations not in Issue	Amts. Paid on Spec. Acct. and Special Stockhold- er's Acct.
1915	\$ 5,058.53	\$ None	\$ None	\$ None	\$ 388.77
1916	2,228.81	25,000.00	None	None	3,701.45
1917	728.69	18,000.00	7,840.00	None	4,837.50
1918	105.43	20,000.00	6,480.00	100.00	6,279.20
1919	792.46	17,500.00	4,400.00	1,335.72	7,714.30
1920	1,876.19	7,500.00	4,400.00	8,253.93	8,770.00
1921	19,122.53	None	2,400.00	4,993.09	12,645.40
1922	18,142.34	None	4,675.00	654.60	13,341.60
1923	18,422.58	None	None	623.67	14,902.19
1924	17,855.34	None	None	118.68	12,595.15
1925	17,384.09	2,500.00	None	150.00	13,255.67
1926	21,542.22	5,000.00	None	1,348.42	13,339.12
1927	36,219.85	None	None	475.00	13,684.36
1928	48,901.34	None	None	None	12,552.66
1929	49,969.10	None	None	570.87	12,841.30
1930	53,776.75	None	None	3,152.70	13,044.00
1931	53,063.90	None	None	1,831.88	5,607.93
1932	49,636.64	None	None	1,984.60	None
1933	49,486.08	None	None	387.33	None
1934	48,861.34	None	None	80.33	None
1935	47,689.40	None	None	None	None
1936	48,675.20	None	None	None	None
1937	48,685.46	12,500.00	2,200.00	1,172.38	15,760.00
1938	48,687.22	9,585.00	None	None	16,428.00

In 1939, the taxpayer's income tax returns for 1937 and 1938 were examined by the Commissioner and a deficiency in income tax was proposed for that year on the basis of a disallowance of the interest deduction taken for the interest paid to the stockholders on the amounts in the Special Stockholders' Account. The taxpayer filed a protest to the proposed determination and a subsequent agreement was

reached whereby the tax returns were accepted as correct. (R. 39-40.)

On June 5, 1939, a special meeting of the taxpayer's stockholders was held in which a resolution was adopted. The minutes of the meeting were, in part, as follows (R. 40):

It was duly moved, seconded and carried unanimously that the Stockholders Accounts on books of Wilbur Security Company, which total \$200,000.00 shall be paid off and distributed to the owners thereof, viz:

J. McPherson	Stockholders Account	\$102,000.00
E. L. Farnsworth,	Stockholders Account	72,000.00
G. Thompson,	Stockholders Account	16,000.00
E. H. Oswalt,	Stockholders Account	6,000.00
Elizabeth McPherson	Stockholders Account	4,000.00
		<hr/>
		\$200,000.00

and further, that the Secretary of Wilbur Security Company, G. Thompson, is hereby directed and empowered to pay off and distribute the said Stockholders Accounts to the owners thereof.

The \$200,000 was withdrawn from the Special Stockholders' Account and the same amount was re-deposited with the other funds in the Special Account. This transaction was accomplished by book-keeping entries without transferring cash between the taxpayer and the stockholders. From this time on, only stockholders and members of the immediate families of stockholders held interests in the Special Account. (R. 40-41.)

On January 20, 1943, the taxpayer's board of directors passed a resolution which provided, in part, as follows (R. 41):

It was duly moved, seconded and carried that all our Special Accounts Payable, on which we pay interest, shall be changed over to Bills Payable, as of January 1, 1943. That the Secretary shall prepare proper notes of the Wilbur Security Company for each of said Special Accounts Payable, dating same January 1, 1943, due one year after date, and bearing interest at rate of 5 per cent per annum. That, these said Bills Payable shall be signed for the Company by its [sic] President and attested by its Secretary.

Following this action, the secretary prepared bills payable to the respective holders of interests (who were all stockholders or members of their immediate families) in the new Bills Payable Account, to pay 5% interest for one year. At the end of each year thereafter, up to 1955, the taxpayer's directors renewed these bills to pay a specified rate of interest or cancelled the old notes and issued new notes for the same amounts without approval from those non-stockholders who held interest in the Bills Payable Account. The directors endeavored to fix the interest rate annually so that it would be slightly above that of the prevailing rate paid by lending institutions. At the same time, in fixing the annual interest rate, the directors took into account the taxpayer's earnings. The notes remained in the taxpayer's possession at all times and none of the nonstockholders ever saw them, although some knew of them. (R. 41-42.)

The notes executed for 1952, on December 31, 1951, were originally issued to provide for 5% interest per annum. On November 4, 1952, the board of directors increased this interest rate to 6%. In 1956 the nomenclature of this account was changed to Notes Payable at the advice of Laurence D. Morse, the certified public accountant who handled the books of the taxpayer, because the term Bills Payable was deemed to be old-fashioned. (R. 42.)

The status of the Bills Payable Account from 1939 to 1955 and a comparison of that account to the stock account for those years were (R. 42) as follows (R. 43-44):

Year	E. L. Farnsworth	Sarah A. Farnsworth	Grace Phillips	J. McPherson	G. Thompson
1939	\$169,790.55—90	\$		\$190,000.00—1221½	\$16,000.00—20
1940	157,790.55—90			187,000.00—1221½	16,000.00—20
1941	81,081.47	73,096.74—90		171,000.00—1021½	16,000.00—20
1942		99,829.80—90	44,298.60	144,000.00—1021½	16,000.00—20
1943		96,829.80—90	50,298.60	144,000.00—1021½	16,000.00—20
1944		93,829.80—90	53,298.60	144,000.00—1021½	16,000.00—20
1945		90,829.80—90	56,298.60	144,000.00—1021½	16,000.00—20
1946		75,829.80—90	71,298.60	144,000.00—1021½	16,000.00—20
1947		72,829.80—90	74,298.60	144,000.00—1021½	16,000.00—20
1948		69,829.80—90	77,298.60	144,000.00—1021½	16,000.00—20
1949		66,829.80—90	80,298.60	144,000.00—1021½	16,000.00—20
1950		63,829.80—90	83,298.60	144,000.00—1021½	16,000.00—20
1951		63,829.80—90	83,298.60	144,000.00—1021½	16,000.00—20
1952		63,829.80—90	83,298.60	144,000.00—1021½	16,000.00—20
1953		63,829.80—90	83,298.60	144,000.00—1021½	16,000.00—20
1954		63,829.80—90	83,298.60	144,000.00—1021½	16,000.00—20
1955			147,128.40—90	144,000.00—1021½	16,000.00—20

Year	E. H. Oswalt	Elizabeth McPherson	J. K. McPherson	Kate McPherson	Julia McPherson	Catherine Bernhard
1939	\$6,000.00—71½	\$4,000.00—5	\$ 8,000.00—5	\$87,000.00	\$99,390.00	\$
1940	6,000.00—71½	4,000.00—5	8,000.00—5	87,000.00	99,390.00	
1941	6,000.00—71½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	
1942	6,000.00—71½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1943	6,000.00—71½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1944	6,000.00—71½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1945	6,000.00—71½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1946	6,000.00—71½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1947	6,000.00—71½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1948	6,000.00—71½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1949	6,000.00—71½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1950	6,000.00—71½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1951	6,000.00—71½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1952	6,000.00—71½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1953	6,000.00—71½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1954	6,000.00—71½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1955	6,000.00—71½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00

The monies in the Grace Phillips account prior to 1940 were deposited there for her by E. L. Farnsworth, her father, who took care of her finances. In 1940, E. L. Farnsworth died and his stock, plus an amount in excess of \$800 per share, was then transferred to the account of Sarah A. Farnsworth, his widow. Of the remaining funds left in the Special Account to the account of E. L. Farnsworth, approximately \$69,000 was used to pay inheritance taxes. Sarah A. Farnsworth died in 1951. Her stock and interest in the then Bills Payable Account were held under that name until 1954 when they were transferred to the account of Grace Phillips, her daughter. On January 1, 1953, the taxpayer disbursed \$14,000 to Grace Phillips, as executrix of the Estate of Sarah A. Farnsworth, for the purpose of settling that estate. The total of Bills Payable for the year was shown as the gross amount undiminished by the \$14,000 on the balance sheet, but the minutes of the directors' meeting and the 1953 tax return reflect both the gross amount and the net amount in that account. The \$14,000 was redeposited with the taxpayer on January 4 and 12, 1954, by Grace Phillips to the credit of the estate. (R. 45.)

The relationship between stockholders, and between stockholders and those owning interests in the Bills Payable Account was as follows (R. 46) :

D. K. McPherson	
J. McPherson	Son of D. K. McPherson
Kate McPherson	Daughter of D. K. McPherson
Julia McPherson	Daughter of D. K. McPherson
Elizabeth McPherson	Wife of J. McPherson
J. K. McPherson	Son of J. McPherson

Catherine Bernhard	Daughter of J. McPherson
E. L. Farnsworth	
Sarah A. Farnsworth	Wife of E. L. Farnsworth
Grace L. Phillips	Daughter of E. L. Farnsworth

The members of the McPherson and Farnsworth families have maintained a close, friendly relationship through the years. (R. 46.)

From 1941 to 1955 the members of the board of trustees (or directors) consisted of five of the stockholders, as provided for by the by-laws. These were (R. 46) :

John McPherson	Godfrey Thompson
John K. McPherson	Grace L. Phillips
E. H. Oswalt	

The taxpayer's officers from 1941 to 1955 were as follows (R. 46) :

John McPherson	President
J. K. McPherson	Vice President
Godfrey Thompson	Secretary

The taxpayer's surplus, dividends, salaries, interest paid on obligations not in issue, and interest paid on the Special Account or Bills Payable Account from 1939 through 1955 (R. 46) were as follows (R. 47) :

Year	Surplus	Dividends	Salaries	Interest Paid on Obligations not in Issue	Amts. Paid on Spec. Acct. or Bills Pay- able Acct.
1939	\$ 51,367.39	\$ 5,000.00	\$ None	\$ None	\$17,016.90
1940	52,734.52	7,500.00	None	None	17,195.40
1941	56,741.77	7,500.00	None	203.33	21,559.50
1942	75,819.90	7,500.00	5,000.00	162.90	27,475.92
1943	69,140.93	7,500.00	5,000.00	None	27,596.75
1944	73,864.99	7,500.00	5,000.00	None	27,625.92
1945	79,082.44	7,500.00	5,000.00	None	27,625.92
1946	84,553.48	25,000.00	8,000.00	None	27,625.92
1947	98,158.21	25,000.00	12,000.00	None	27,625.92
1948	105,328.30	25,000.00	18,000.00	None	27,625.92
1949	109,838.21	25,000.00	18,000.00	None	27,625.92
1950	128,977.48	25,000.00	18,000.00	None	27,625.92
1951	129,107.95	25,000.00	18,000.00	None	27,625.92
1952	147,238.25	25,000.00	18,000.00	None	33,151.10
1953	147,541.62	25,000.00	18,000.00	None	32,311.10
1954	164,121.39	25,000.00	18,000.00	None	33,151.10
1955	166,872.50	25,000.00	18,000.00	None	33,151.10

The taxpayer's balance sheet for the years in question was as follows (R. 47-48) :

ASSETS	1953	1954	1955
Current Assets			
Cash in bank	\$ 2,315.55	\$ 54,938.74	\$ 35,119.82
Bills Receivable	304,095.73	269,161.64	283,176.36
Investment in Stocks	500.00	500.00	500.00
Fixed Assets			
Farm properties and buildings	438,148.74	437,039.41	445,594.72
Total assets	<u>\$745,060.02</u>	<u>\$761,639.79</u>	<u>\$764,390.90</u>

LIABILITIES AND CAPITAL	<u>1953</u>	<u>1954</u>	<u>1955</u>
Current Liabilities			
Income tax payable, estimated	\$ 20,000.00	\$ 20,000.00	\$ 20,000.00
Notes payable	552,518.40	552,518.40	552,518.40
Capital			
Capital stock	25,000.00	25,000.00	25,000.00
Surplus	<u>147,541.62</u>	<u>164,121.39</u>	<u>166,872.50</u>
Total liabilities and capital	<u>\$745,060.02</u>	<u>\$761,639.79</u>	<u>\$764,390.90</u>

The Commissioner disallowed all interest deductions for monies paid as interest on the Bills Payable Account and determined that the account represented the actual invested capital of the taxpayer. (R. 48.)

The Tax Court found that the amounts outstanding in the taxpayer's Bills Payable Account constituted equity capital invested in its business, and that the payments of \$32,311.10 in 1953, \$33,151.10 in 1954, and \$33,151.10 in 1955 on the Bills Payable Account were distributions of dividends. (R. 48.)

SUMMARY OF ARGUMENT

A. The taxpayer paid what is alleged to be "interest" to certain individuals who advanced money to it in order for it to start and pursue its corporate business and acquire income-producing properties. The taxpayer deducted these disbursements on its tax returns, claiming that they were paid on account of an "indebtedness" within the meaning of Section 23(b) of the 1939 Code. The trial court found, however, that as a matter of fact the advances represent

capital contributions to the taxpayer rather than debts, and, secondly, that the disbursements to note-holders constitute non-deductible dividend payments. The question whether advances to a corporate taxpayer constitute capital investments or indebtedness is one of fact and the trial court's finding is final unless clearly erroneous. Not only is the Tax Court's finding here *not* clearly wrong, but it is *fully* supported by the record.

Contrary to the taxpayer's argument, the fact that advances are evidenced by notes having definite maturity dates and a fixed obligation to pay interest does not end the controversy. That is so because those formalisms may not represent the true agreement of the parties, or may only partially represent such agreement. The question being one of substance over form, it matters not what the parties call their transaction—if the evidence taken as a whole shows a stockholding relationship the advances cannot be treated as debts. This factual determination must take into consideration the history of the notes, their treatment by the parties, and all of the surrounding circumstances.

Each case must be decided upon its own facts and hence there are no all-inclusive rules to be applied. However, the trial court is guided in its determination by many judicial signposts recognized by the appellate courts. Each of those signposts represents either an *indicium* of a stockholding relationship or an *indicium* of a debtor-creditor relationship. The taxpayer, seeking a deduction, bears the burden of showing that the preponderance of circumstances are

those which are characteristic of a debtor-creditor relationship.

B. Two groups of individuals advanced money to the taxpayer and held its notes, namely, those who held certificates of stock and those who did not. The Tax Court properly held that the taxpayer's payments to each constituted dividends and not deductible interest.

1. The notes which the taxpayer issued to shareholders for their advances do not to any extent represent the true circumstances. Considering all of the record facts, the preponderance of the evidence indicates a stockholding relationship, and the characteristics of a debtor-creditor relationship are almost nonexistent. Some of the factors showing that the payments in question constituted dividends rather than interest are as follows: There was in fact no fixed maturity date (notwithstanding the provisions of the notes that shareholders held, the advances remained with the taxpayer for indefinite periods which up through the taxable years in question amounted in some instances to approximately four-fifths of its corporate life of fifty years); so-called "interest" payments depended upon the taxpayer's earnings; the determination of whether interest would be paid and the amount thereof was solely in the discretion of the taxpayer's board of directors; the notes were not paid on due dates; there was no attempt to enforce payment of the notes though due dates were annually violated; the advances were used broadly to enable the taxpayer to start its business and acquire *all* of its income-producing properties; the ad-

vances were unsecured; the notes were in fact not negotiable because they never left the taxpayer's possession; and outsiders would not have made the advances under like circumstances, to wit, for an indefinite length of time, in effect subject to the risks of the business, and the return thereon being exclusively within the discretion of the taxpayer's board of directors.

The factors summarized constitute almost all of the well-recognized earmarks of venture or risk capital and it is obvious that the Tax Court's finding, after a painstaking review of all the evidence, that the interest of the shareholders who also held notes was an equity interest and the taxpayer's disbursements on account thereof constitute non-deductible dividends, is not clearly erroneous.

2. The Tax Court's finding that advances made to the taxpayer by members of the immediate families of stockholders also constituted contributions to capital is likewise fully supported by the record and not clearly erroneous. The same circumstances described as existing with respect to advances made by shareholders exist here; that is, the characteristics of a stockholding relationship prevail while almost none of the characteristics of a debtor-creditor relationship are to be found.

Contrary to the taxpayer's apparent position, since the overwhelming weight of the evidence shows that the interests of these noteholders were equity interests, the fact that the notes did not confer the right to vote does not require, as a matter of law, a finding

different from that made by the Tax Court. Many stock interests, such as preferred stock, do not confer the right to vote or to participate in management, but nevertheless the holders of such interests are *not* creditors of the corporation.

Moreover, it is to be noted that it is not necessary, in order for an equity or stock interest to exist, that the formalisms of a stock issue be observed. If advances are such that they are accompanied with a preponderance of characteristics which accord with a stockholding relationship, the holder of notes representing those advances is treated as a stockholder under the Code.

ARGUMENT

THE TAX COURT'S FINDING, THAT THE AMOUNTS OUTSTANDING IN THE TAXPAYER'S "BILLS PAYABLE ACCOUNT" CONSTITUTE EQUITY CAPITAL INVESTED IN ITS BUSINESS AND THAT PAYMENTS MADE BY THE TAXPAYER TO THOSE WHO OWNED AN INTEREST IN THAT ACCOUNT WERE NON-DEDUCTIBLE DISTRIBUTIONS OF DIVIDENDS, IS FULLY SUPPORTED BY THE RECORD AND NOT CLEARLY ERRONEOUS

A. The principles involved

This case involves the oft-litigated issue as to whether payments made by a corporation to those who have advanced funds to it constitute dividends or interest. The taxpayer contends that the payments constitute interest and that, therefore, it can deduct the disbursements under Section 23(b) of the

Internal Revenue Code of 1939, *supra*.² However, if the payments were in reality distributions of corporate profits on account of the recipients' investments in the corporate business, then the disbursements are not deductible.

Of course, since deductions are a matter of legislative grace, the taxpayer bears the burden of showing clearly that the questioned disbursements constitute interest payments. The question is necessarily factual and the finding of the trial court is final unless "clearly erroneous". *O'Neill v. Commissioner*, 271 F. 2d 44 (C.A. 9th); *Earle v. W. J. Jones & Son*, 200 F.2d 846, 847 (C.A. 9th); *Gooding Amusement Co. v. Commissioner*, 236 F. 2d 159, 166 (C.A. 6th), certiorari denied, 352 U. S. 1031; *Matthiessen v. Commissioner*, 194 F. 2d 659, 662 (C.A. 2d); *Bair v. Commissioner*, 199 F. 2d 589, 591 (C.A. 2d). Moreover, since many types of equity interests are similar to an indebtedness in that the holder of the obligation is preferred over other stockholders and has no right to vote or participate in management, the question is sometimes a close one involving the weighing of many factors to arrive at the practical effect of all the circumstances. We here summarize the approach uniformly taken by the courts that have considered the question.

² For convenience, we refer in our argument only to Section 23(b) of the 1939 Code; however, Section 163(a) of the Internal Revenue Code of 1954 (26 U.S.C. 1958 ed., Sec. 163), which contains provisions substantially the same as those found in 1939 Code Section 23(b), applies to the taxable years 1954 and 1955 here involved.

The classic debt is an unqualified obligation to pay a sum certain at a fixed maturity date, with a fixed percentage of interest, payable regardless of the debtor's income or lack thereof. Congress when using the term "indebtedness" in the Code uses it in its ordinary sense, that is, the advances must in fact be of the nature of an indebtedness. Accordingly, where advances are substantially lacking in the attributes of the classic debt they will be precluded from treatment as such under the federal taxing statute (*241 Corp. v. Commissioner*, decided July 25, 1956 (1956 P-H T.C. Memorandum Decisions, par. 56,174), affirmed *per curiam*, 242 F. 2d 759 (C.A. 2d), certiorari denied, 354 U.S. 938; *Beaver Pipe Tools, Inc. v. Carey*, 139 F. Supp. 470, 471-472 (N.D. Ohio), affirmed *per curiam*, 240 F. 2d 843 (C.A. 6th), certiorari denied, 353 U.S. 958; *Root v. Commissioner*, 220 F.2d 240, 241 (C.A. 9th); *May Hosiery Mills v. Commissioner*, 123 F.2d 858, 860 (C.A. 4th); *Haffenreffer Brewing Co. v. Commissioner*, 116 F. 2d 465, 468 (C.A. 1st), certiorari denied, 313 U.S. 567; *Jewel Tea Co. v. United States*, 90 F.2d 451, 453 (C.A. 2d)); however, a slight variation will not of itself preclude such treatment (see *Miller's Estate v. Commissioner*, 239 F.2d 729 (C.A. 9th); *United States v. Title Guarantee & Trust Co.*, 133 F.2d 990, 995 (C.A. 6th)).

On the other hand, the fact that advances take the form of debts in all details does not end the controversy. If, for example, the notes are a mere pretense in that the parties actually entered into an *entirely* different agreement by which their rights

were to be governed, then there is not even a need to apply the various judicial guides which have arisen in this area to answer the question, for it would be clear that the notes represent mere formalisms disguising the true relationship. The *motive* for so disguising the transaction is immaterial—the significant point is that in reality the recognized and fundamental earmarks of a debt which is represented by the notes are missing. *Gilbert v. Commissioner*, 248 F.2d 399, 404, 408 (C.A. 2d). However, if the notes do not represent pure formalisms, but in part truly evidence *some* of the characteristics of a debtor-creditor relationship, then the question is still whether the evidence, taken as a whole, shows a stockholding relationship. *Brinker v. United States*, 116 F. Supp. 294, 297 (N.D. Cal.), affirmed *per curiam*, 221 F.2d 478 (C.A. 9th); *Gilbert v. Commissioner*, 262 F.2d 512, 513 (C.A. 2d), certiorari denied, 359 U.S. 1002; *Gilbert v. Commissioner*, 248 F.2d 399, 403 (C.A. 2d); *Reed v. Commissioner*, 242 F.2d 334, 335 (C.A. 2d); *Sarkes Tarzian, Inc. v. United States*, 240 F.2d 467, 470 (C.A. 7th); *United States v. Title Guarantee & Trust Co.*, 133 F.2d 990, 995 (C.A. 6th). In that event the question is determined by many factors each of which represents either an *indicium* of a stockholding relationship or an *indicium* of a debtor-creditor relationship. No one characteristic here is controlling—the decision must be reached by a weighing of the factors in the particular record under scrutiny. *John Kelley Co. v. Commissioner*, 326 U. S. 521, 530; *Earle v. W. J. Jones & Son*, 200 F.2d 846, 847 (C.A. 9th); *Lee Telephone Co. v. Commissioner*,

decided December 16, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,230), affirmed, 260 F.2d 114 (C.A. 4th); *Reed v. Commissioner*, 242 F.2d 334, 335 (C.A. 2d); *Gooding Amusement Co. v. Commissioner*, 236 F. 2d 159, 165 (C.A. 6th), certiorari denied, 352 U.S. 1031; *Crawford Drug Stores, Inc. v. United States*, 220 F.2d 292, 296 (C.A. 10th).

From the foregoing it is readily apparent that, although advances may take the form of debts, and although a shareholder may testify that he did not intend to make a capital investment, the facts may show that the advances were in their fundamental nature venture or risk capital, and since such attributes were intended, there was a stockholding relationship under the taxing statute. *Beaver Pipe Tools, Inc. v. Carey*, 139 F. Supp. 470, 472 (N.D. Ohio), affirmed *per curiam*, 240 F. 2d 843 (C.A. 6th), certiorari denied, 353 U.S. 958; *Gilbert v. Commissioner*, 248 F.2d 399, 406-407 (C.A. 2d); *Gilbert v. Commissioner*, 262 F.2d 512, 514 (C.A. 2d), certiorari denied, 359 U.S. 1002; *Elko Lamoille Power Co. v. Commissioner*, 50 F.2d 595, 596 (C.A. 9th); cf. *Starr v. Commissioner* (C.A. 9th), decided December 29, 1959 (60-1 U.S.T.C., par. 9191).

In short, the basic inquiry is aimed at ascertaining whether the advances were in reality an investment in the business, the return thereon being based upon the risk of the venture, or whether they were based on a definite obligation of the taxpayer to provide a return in any event within reasonable and fixed periods of time. *Root v. Commissioner*, 220 F.2d 240, 241 (C.A. 9th); *Arlington Park Jockey Club v.*

Sauber, 262 F.2d 902, 905 (C.A. 7th); *Beaver Pipe Tools, Inc. v. Carey*, 139 F. Supp. 470, 471-472 (N.D. Ohio), affirmed *per curiam*, 240 F. 2d 843 (C.A. 6th), certiorari denied, 353 U.S. 958; *Dittmar v. Commissioner*, 23 T.C. 789, 797.

In accordance with the distinctions discussed, the courts, as previously noted, have decided that certain guides should be applied by the finder of fact (none being controlling and not all being found in any one given case), some of which are as follows: whether there was in fact a fixed date for payment of interest and for repayment of principal; whether payments depended upon earnings; whether notes were paid on their maturity dates; whether there was any attempt to enforce payment on due dates; the use to which the advances were put; whether outsiders would have made the advances under like circumstances; whether the advances were secured; whether the notes were negotiable; whether there was participation in management; the formal designation used by the parties; if the parties making the advances were formal stockholders, whether the advances were in proportion to stockholdings; and the relationship between advances which were concededly risk capital and those which were denoted as debts (the debt-equity ratio).³

³ Some of the cases applying and discussing these standards are: *Root v. Commissioner*, 220 F.2d 240 (C.A. 9th); *Arlington Park Jockey Club v. Sauber*, 262 F.2d 902 (C.A. 7th); *Gilbert v. Commissioner*, 262 F.2d 512 (C.A. 2d), certiorari denied, 359 U.S. 1002; *Kolkey v. Commissioner*, 27 T.C. 37, affirmed, 254 F.2. 51 (C.A. 7th); *Gilbert v. Commissioner*, 248 F.2d 399 (C.A. 2d); *Crawford Drug*

The Tax Court applied the principles discussed to the record, and, performing its function as the trier of fact, after a painstaking review of all the evidence, found that the advances in question constituted capital investments in the taxpayer's business. (R. 49-56.) Accordingly, it concluded that the taxpayer's disbursements to holders of the notes in question constituted dividends not deductible by the taxpayer as interest under Section 23(b) of the 1939 Code. (R. 48, 56.) Since some of the holders of notes to which the taxpayer made the disbursements in question were holders of stock certificates and some were not, we will discuss the two groups separately under Point B, *infra*, although the Tax Court reached the same conclusion as to each.

B. The Tax Court correctly found that the taxpayer's disbursements which it deducted as interest under Section 23(b) of the 1939 Code were non-deductible dividend payments

1. *The payments by the taxpayer to shareholders because of their advances made to it constitute dividends*

During the taxable years 1953, 1954 and 1955, the taxpayer paid what it alleges to be "interest" to holders of its notes who were also its stockholders. On its tax returns for those years the taxpayer deducted those payments, under Section 23(b) of the

Stores, Inc. v. United States, 220 F.2d 292 (C.A. 10th); *Harkins Bowling, Inc. v. Knox*, 164 F. Supp. 801 (Minn.), appeal dismissed (C.A. 8th), January 19, 1959; *Hoguet Real Estate Corp. v. Commissioner*, 30 T.C. 580.

1939 Code, as being allegedly incurred on account of "indebtedness". (R. 48.) The Tax Court found (R. 48, 55, 56), however, that the taxpayer did not carry its burden of showing by a preponderance of the evidence that the advances made by the shareholders were not advances of additional capital, but, on the contrary, the preponderance of the evidence shows that the advances were equity capital invested in the taxpayer's business and that the amounts paid on account of those advances constituted dividends and not deductible interest.

The taxpayer attacks the findings of fact by the Tax Court on the ground that, if attention is directed only to the form of the transaction during the taxable years in question, none of the characteristics of a stockholding relationship exist because the notes issued by it were absolute on their face, having a definite maturity date of one year and a definite obligation to pay a fixed rate of interest. (Br. 10-13, 18-22.) In this manner the taxpayer seeks to pursue formalisms and ignore substance, but as we shall show, the notes here do not represent the substance of the transaction to any degree, and, as the trial court observed (R. 55), they merely serve to disguise the true nature of the amounts contained in the taxpayer's "Bills Payable Account".⁴

⁴ It should be noted, however, that the *motive* for issuing notes which do not represent the true relationship of the parties is immaterial. The crucial fact is, as discussed under Point A, *supra*, that the notes are artificial in that they do not represent the true circumstances—whether the motive initially was to avoid taxes or not, the fact is that

Of course, the taxpayer's attempt to obscure substance by emphasizing formalities can not be reconciled with the cases previously cited. See Point A, *supra*. The settled rule is that the courts are not limited to formalisms, however meticulously observed, in which the parties cast their transactions. The trial court's duty, made necessary by the Congressional enactment of Section 23(b), is to determine whether the taxpayer's deduction of alleged "interest" payments was proper; to do this, it must determine whether the taxpayer has clearly shown that the payments were made on account of an "indebtedness" within the meaning of the Code. In reaching its determination that court is not required to close the judicial eyes to what all others can see. Accordingly, the determination of the question *must* take into consideration the history of the notes, their treatment by the parties, and all of the surrounding circumstances. *John Kelley Co. v. Commissioner*, 326 U.S. 521, 526; *Brinker v. United States*, 116 F. Supp. 294, 297 (N.D. Cal.), affirmed *per curiam*, 221 F.2d 478 (C.A. 9th); *Lockwood Realty Corp. v. Commissioner*, decided March 31, 1958 (1958 P-H T.C. Memorandum Decisions, par. 58,049), affirmed *per curiam* on this issue, 264 F.2d 241 (C.A. 6th); *Kolkey v. Commissioner*, 27 T.C. 37, 57, affirmed, 254 F.2d 51 (C.A. 7th); *Gregg Co. of Delaware v. Commissioner*, 239 F.2d 498, 502 (C.A. 2d), certi-

at this point the taxpayer alleges that the form is supreme and that the substance may be hidden by that form. See *Gilbert v. Commissioner*, 262 F.2d 512, 514 (C.A. 2d), certiorari denied, 359 U.S. 1002.

orari denied, 353 U.S. 946. Cf. *Ehrman v. Commissioner*, 120 F.2d 607, 610 (C.A. 9th), certiorari denied, 314 U.S. 668; *Lockhart v. Commissioner*, 258 F. 2d 343, 348 (C.A. 3d).

(a) *The history of shareholder advances
from 1915 to 1943*

The taxpayer was incorporated on March 18, 1915, for the purpose of holding long-term paper which the Wilbur State Bank was not permitted to carry. (R. 28.) Additionally, it was given the power to hold and operate real estate properties. (R. 29.) The corporate life was to exist for 50 years from the date of incorporation. (Ex. 5-E.)⁵ During the taxable years in question, the taxpayer carried on its books a "Bills Payable Account" and the major portion of the advances which constituted that account was donated by stockholders. (R. 43-44.) Of the amount advanced by stockholders, \$200,000 was advanced on April 5, 1915, and was held in a "Special Stockholders' Account" from 1915 through 1938. (R. 34.) That amount was advanced by the stockholders in direct proportion to the amount of stock each owned, that is, the advances represented \$800 for each share of stock. These accounts could not be withdrawn by any of the stockholders except by consent of two-thirds of the capital stock voted in the taxpayer at any regular or special stockholders' meeting. (Ex. 6-F; R. 32-33.) Additionally, if any stock was sold, \$800 of the advances were required to be

⁵ Copies of all exhibits referred to in this brief are being submitted, in quadruplet, for the use of the Court.

transferred with each share of stock thus sold. (R. 33, 35.) These regulations with respect to the initial \$200,000 advance were in existence during the taxable years in question. (R. 33, 53.) In addition, the stockholders advanced other monies to an account of the taxpayer titled the "Special Account". (R. 36-37, 40.)

At the time the shareholders advanced the \$200,000 discussed above, the taxpayer was possessed of no paid-in capital (R. 163); however, by December of 1916 the taxpayer had accumulated earnings of \$25,000, and that money was set aside as paid-in capital (R. 33).

In 1939 the advances represented by the "Special Stockholders' Account", which were always kept in exact proportion to stock ownership, were transferred to the "Special Account". From this time on all of the advances of the stockholders were kept in one consolidated account. (R. 34-35, 40-41.) The proportionate interest of stock to the original advance which was made part of the "Special Account" continued. The consolidation of the accounts occurred after the Commissioner examined the taxpayer's books and questioned the interest payments. (R. 53.) The consolidation of the accounts was understood by the stockholders as being a mere book transaction, in that all that was done was that the two accounts were moved together. (R. 154, 178-179.)

The situation remained as outlined until the year 1943. Up to that period those who remained stockholders allowed their advances to stay with the taxpayer for more than one-half of its corporate life.

(R. 35-37, 41, 43-44; Ex. 5-E.) So far as the record shows, during this period the shareholders received no security for any of their advances; they received no evidence of any indebtedness; there was no fixed maturity date for repayment of principal; there was no obligation on the part of the taxpayer to pay interest at any rate, no less a fixed rate; and there was no right to enforce repayment of the amounts advanced. (R. 51-53, 142, 186-187.) Moreover, although during bad times the shareholders received no return on their advances, other creditors received a return on their loans. (R. 39.) The shareholders understood that, as in the case of their dividends, they could expect no return in bad years. (R. 136.) Any so-called interest payments that were received by the shareholders during this period were obviously at the sole discretion of the directors of the taxpayer and, so far as the record discloses, the shareholders made no demand for payment of interest, or repayment of principal.

At this juncture in the case, it is crystal clear that the shareholders' advances did not constitute debts upon which payments of "interest" may be deducted under the Code. The advances completely lacked all of the signposts of a debtor-creditor relationship. Thus, there did not exist an unqualified obligation to pay a sum certain at a fixed maturity date, with a fixed percentage of interest, payable regardless of the debtor's income or lack thereof. Hence, as a matter of law, the payments in question which the taxpayer made to shareholders were not made on account of an "indebtedness" within the meaning of 1939 Code Sec-

tion 23(b). *Root v. Commissioner*, 220 F.2d 240, 241 (C.A. 9th); *Beaver Pipe Tools, Inc. v. Carey*, 139 F. Supp. 470, 471-472 (N.D. Ohio), affirmed *per curiam*, 240 F.2d 843 (C.A. 6th), certiorari denied, 353 U.S. 958; *241 Corp. v. Commissioner*, decided July 25, 1956 (1956 P-H T.C. Memorandum Decisions, par. 56,174), affirmed *per curiam*, 242 F.2d 759 (C.A. 2d), certiorari denied, 354 U.S. 938; *May Hosiery Mills v. Commissioner*, 123 F.2d 858, 860 (C.A. 4th); *Haffenreffer Brewing Co. v. Commissioner*, 116 F.2d 465, 468 (C.A. 1st), certiorari denied, 313 U.S. 567; *Jewel Tea Co. v. United States*, 90 F.2d 451, 453 (C.A. 2d).

Moreover, almost every factor considered by the courts as evidencing a stockholding relationship was present. Thus, in addition to the facts that there was no fixed maturity date and no obligation to pay a fixed rate of interest regardless of the taxpayer's income or lack thereof, we have, as previously discussed, the following facts: The advances were left with the business indefinitely and thus completely subject to the risks of the business and, in effect, subordinated to all outside creditors; the advances were (R. 38, 166-168) used generally by the taxpayer to start the operation of its business and to acquire all of its business property; the shareholders who advanced the funds all had the right to vote; all returns on the advances depended upon the success of the business and those who made the advances did not expect a return during bad years; there was never any right, or attempt, to collect interest or principal; and the advances were all unsecured.

In short, all of the characteristics of a stockholding relationship existed at this time, and had so existed for a period of twenty-eight years. Indeed, the only difference between the advances in question and those which were concededly equity investments was that the latter were represented by stock certificates. On the other hand, as we have pointed out, none of the characteristics of a debtor-creditor relationship existed. Hence, as previously noted, as a matter of law, the advances could not at this juncture be considered debts giving rise to deductible interest payments under the Code.

(b) *The status of the shareholder advances from the year 1943 through the taxable years 1953, 1954 and 1955*

The taxpayer asks this Court to ignore the history we have just discussed and relies wholly upon events that occurred in the year 1943 (Br. 9-14, 18, 22), which it apparently believes changed the entire picture. During that year the "Special Accounts Payable" nomenclature was changed to "Bills Payable", and notes were issued for each of the "Special Accounts Payable". The notes were dated January 1, 1943, due one year after date, and bearing interest at the rate of 5%. (R. 41.) The reason for these new formalisms was testified to by the taxpayer's own witness as being the taxpayer's response to notification by an Internal Revenue Agent that interest could only be paid on notes. (R. 153.)

The pertinent inquiry now is to determine whether or not the new formalisms changed the substance of what had existed for the previous 28 years.

First of all, the record discloses that the notes remained in the possession of the taxpayer, thus rendering them for all practical purposes non-negotiable. (R. 53.) In fact, so far as the record shows none of the notes were negotiated. Notwithstanding the absolute provision for interest contained on the notes, the real circumstance was that the noteholders did not determine whether interest could be paid or, if so, the amount of interest that would be paid. The payment of interest and the amount thereof was wholly within the discretion of the taxpayer's directors. (R. 186-187.) The directors exercised their discretion by taking into consideration the earnings of the taxpayer. (R. 53.) Accordingly, the so-called interest payments actually varied, reflecting such consideration. The taxpayer altered the notes without conferring with the holders thereof. (R. 53-54.) Although the notes contained a fixed maturity date of one year, they were in fact never paid. The taxpayer automatically issued new notes each year, marking the old ones as paid, or sometimes merely renewed the old notes. The stockholders who happened to be at the directors' meetings never objected, and other noteholders were never consulted. (R. 53, 101, 142.) The advances continued to be unsecured and none of the noteholders demanded repayment of principal although past due according to the terms of the notes. Accordingly, up to and including the taxable years most of the advances made by shareholders had remained with the corporation for a period of 38 years and other advances made by them likewise remained at the taxpayer's disposal for long-

term periods. The record also shows that interest was not cumulative, and in years when not paid it was lost to the noteholders. (R. 181; Ex. 15-O(a).) Further, the record discloses that outsiders (other than stockholders and members of their immediate families) refused to make advances to the taxpayer under like circumstances, to wit, for an indefinite period of time wholly at the risk of the business, the return thereon being exclusively within the discretion of the directors. (R. 183.) Finally, the record shows that, as in the case of any holders of common or preferred stock, neither the noteholders nor the taxpayer believed that any demand for payment would be made—if such demand were made it could have caused the taxpayer's liquidation. (R. 101, 142, 170.)

We submit that the substance of the transactions in issue was not changed by the issuance of the notes from what it was before that event. The notes did not represent the true agreement of the parties and as before none of the characteristics of the classic debt existed, and almost all of the characteristics inherent in a stockholding relationship continued to exist.

Although it is true that the notes themselves did not confer the right to vote, this factor is of little importance with respect to the stockholders who all had the right to vote and had tacitly agreed since 1915 that voting rights would remain in accord with common stock ownership, while the true equity interests would be represented by the accounts which bore different names through the years. See, for example, *Hoguet Real Estate Corp. v. Commissioner*, 30 T.C.

580, 600; *Colony, Inc. v. Commissioner*, 26 T.C. 30, 43, affirmed on another issue, 244 F. 2d 75 (C.A. 6th), reversed, 357 U.S. 28. Cf. *Cleveland Shopping News Co. v. Routzahn*, 89 F.2d 902 (C.A. 6th).

Moreover, many equity interests (i. e., preferred stock) ordinarily contain no voting rights and are held disproportionately by both holders of common stock and individuals who do not own such stock. However, such equity interests have all of the attributes of the "Bills Payable Account" in this case, and the owners thereof are *not* creditors. *Lee Telephone Co. v. Commissioner*, decided December 16, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,230), affirmed, 260 F.2d 114 (C.A. 4th); *Crawford Drug Stores, Inc. v. United States*, 220 F.2d 292, 296 (C.A. 10th); *Green Bay & Western Railroad Co. v. Commissioner*, 3 T.C. 372, 379, affirmed, 147 F.2d 585 (C.A. 7th); *Elko Lamoille Power Co. v. Commissioner*, 50 F.2d 595, 596 (C.A. 9th); *Huisking & Co. v. Commissioner*, 4 T.C. 595, 600.

Under the circumstances disclosed by the record, the only items of evidence that reasonably can be relied upon by the taxpayer are (1) the form of the transactions, and (2) the fact that in later years the taxpayer did not have a debt structure which was greatly in excess of its assets. With respect to the first point, it already has been shown that the notes did not reflect the true relationship of the parties. With respect to the second point, it is exceedingly well settled that no one characteristic is determinative of the present question. Thus, it is uniformly held, for example, in cases where the obligation in-

volved expressly excludes the "creditor" from management and stock investment is not nominal, or where advances are not made in proportion to stockholdings, that the cumulative effect of other circumstances justifies a finding that advances constitute venture capital.⁶ The finding that a corporation was thinly capitalized is merely cumulative. Moreover, although the taxpayer initially was not merely thinly capitalized but had *no* capital at all, and although at all times its *form* indebtedness was always greatly disproportionate to its form capital (R. 47-48, 50), the Tax Court did not rely upon those facts directly for its findings. It merely pointed out some of those factors as being circumstances explaining the taxpayer's actions. (R. 50.) As previously noted, the Tax Court was required to consider all factors and, in accordance with that requirement, it reached its findings after a painstaking review of all circumstances, giving no one factor undue significance. (R. 49-56.)

Reviewing the evidence in this case, it is clear that the characteristics of a stockholding relationship overwhelmingly preponderate, while the characteristics of a debtor-creditor relationship are almost nonexistent. Such circumstances as so-called interest

⁶ *John Kelley Co. v. Commissioner*, 326 U.S. 521, 525-530; *Gilbert v. Commissioner*, 262 F.2d 512, 513 (C.A. 2d), certiorari denied, 359 U.S. 1002; *Gilbert v. Commissioner*, 248 F.2d 399, 410 (C.A. 2d); *Reed v. Commissioner*, 242 F. 2d 334, 335 (C.A. 2d); *Gooding Amusement Co. v. Commissioner*, 23 T.C. 408, 419, affirmed, 236 F.2d 159 (C.A. 6th), certiorari denied, 352 U.S. 1031; *Dittmar v. Commissioner*, 23 T.C. 789, 796.

payments being at the sole discretion of directors and dependent upon the taxpayer's earnings are, of course, not characteristic of an interest obligation but are characteristic of an intent to pay dividends. The facts that there was no fixed maturity date and that advances were allowed to remain with the taxpayer for most of its corporate life disclose that holders of the notes did not intend to enforce payment in any event and that their real position was that of shareholders whose investment is understood to be at the risk of the venture. Further facts in addition to those just mentioned, such as the facts that no demand for payment was made, so-called interest was not cumulative, the notes were not in the possession of those who advanced funds, any attempt to enforce payment of notes would have rendered the taxpayer insolvent, the notes were not secured, etc., clearly disclose that the advances in question constituted venture capital and that the taxpayer's disbursements to noteholders of its profits were dividend payments.⁷

⁷ Some of the cases deciding that advances to corporations constituted contributions to capital under similar circumstances, although not all having the strong cumulative characteristics of a stockholding relationship contained in the present record, are as follows: *Brinker v. United States*, 116 F. Supp. 294, 297 (N.D.Cal.), affirmed *per curiam*, 221 F.2d 478 (C.A. 9th); *Gilbert v. Commissioner*, 262 F.2d 512 (C.A. 2d), certiorari denied, 359 U.S. 1002; *Lockwood Realty Corp. v. Commissioner*, decided March 31, 1958 (1958 P-H T.C. Memorandum Decisions, par. 58,049), affirmed on this issue, 264 F.2d 241 (C.A. 6th); *Lee Telephone Co. v. Commissioner*, decided December 16, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,230), affirmed, 260

The Tax Court's finding here is therefore plainly not clearly wrong. Indeed, the taxpayer has completely failed to meet its burden of clearly establishing its right to the deductions claimed. (See Point A, *supra*.)

2. *The taxpayer's payments to noteholders who did not hold certificates of stock likewise constitute dividends*

Certain individuals who did not own certificates of stock in the taxpayer owned interests in the taxpayer's "Bills Payable Account". (R. 54.) Most of these, who like the stockholders became noteholders in 1943, had left their advances in the accounts of the taxpayer since the early nineteen hundreds. (R. 37, 43-44.) A great portion of these advances was made for those noteholders by the respective heads of their families who were the formal holders of stock in the taxpayer. (R. 45, 135-136.) These noteholders were members of the Farnsworth and McPherson families, which families controlled at least two-thirds of the taxpayer's stock. (R. 54-55.)

F.2d 114 (C.A. 4th); *Reed v. Commissioner*, 242 F.2d 334 (C.A. 2d); *Gooding Amusement Co. v. Commissioner*, 23 T.C. 408, affirmed, 236 F.2d 159 (C.A. 6th), certiorari denied, 352 U.S. 1031; *Matthiessen v. Commissioner*, 194 F.2d 659 (C.A. 2d); *Universal Oil Products Co. v. Campbell*, 181 F.2d 451 (C.A. 7th), certiorari denied, 340 U.S. 850, rehearing denied, 340 U.S. 894; *Prutzman v. Commissioner*, decided December 10, 1953 (1953 P-H T.C. Memorandum Decisions, par. 53,400), affirmed *per curiam*, 218 F.2d 603 (C.A. 2d); *Hoguet Real Estate Corp. v. Commissioner*, 30 T.C. 580; *Huisking & Co. v. Commissioner*, 4 T.C. 595; *Green Bay & Western Railroad Co. v. Commissioner*, 3 T.C. 372, affirmed, 147 F.2d 585 (C.A. 7th).

In order to show that the noteholders here described in fact held equity interests in the taxpayer, and that their advances did not give rise to "indebtedness" within the meaning of Section 23(b), extended discussion is not necessary because the true circumstances underlying the formalisms are precisely the same as those previously discussed with respect to the "stockholders" who also held notes. As was the case with those who held certificates of stock, the following characteristics here prevailed: The notes under discussion were *in fact* not negotiable (the notes always remained in the taxpayer's possession); there was in fact no fixed date for payment of interest and for repayment of principal; payments were in the sole discretion of directors and depended upon earnings; there was no attempt to enforce payment although formal due dates were never complied with; there was no security; the advances remained with the taxpayer invested in its business assets for almost the entire period of its corporate existence; the individuals who made the advances were aware of the fact that the terms of the notes were mere formalisms and that the true characteristics were those which we have just described, etc. (R. 51, 53-54, 135-137, 142, 144, 169-170, 186-187.)

In other words, here, too, almost all of the characteristics of a stockholding relationship exist and almost none of the recognized characteristics of a debtor-creditor relationship are in fact to be found.

Although the notes did not specifically confer the right to vote or participate in management, the noteholders who did not hold common stock in fact had

a representative on the board of directors. (R. 46, 54.) Furthermore, the interests of these noteholders bore the substantial earmarks of equity interests, and the lack of voting rights under the record facts merely puts the noteholders in the same status as preferred stockholders. See discussion and cases cited under Point B-1, *supra*.

Of course, at this late date it would be trite to contend that individuals cannot be deemed to be possessed of equity or stock interests in a corporation merely because none of the formalisms have been observed. If advances are such that they are accompanied with a preponderance of characteristics which accord with a stockholding relationship, the holder of notes representing those advances is treated as a stockholder under the Code. *O'Neill v. Commissioner*, decided October 11, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,193), affirmed, 271 F.2d 44 (C.A. 9th); *Lee Telephone Co. v. Commissioner*, decided December 16, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,230), affirmed, 260 F.2d 114 (C.A. 4th); *Universal Oil Products Co. v. Campbell*, 181 F.2d 451, 476-477 (C.A. 7th), certiorari denied, 340 U.S. 850, rehearing denied, 340 U.S. 894; *Green Bay & Western Railroad Co. v. Commissioner*, 3 T.C. 372, 379, affirmed, 147 F.2d 585 (C.A. 7th); *Kalech v. Commissioner*, 23 T.C. 672, 681-682; *Huisking & Co. v. Commissioner*, 4 T.C. 595, 599-600; *Thomas v. Commissioner*, 2 T.C. 193, 196; *Gale v. Commissioner*, decided April 30, 1956 (1956 P-H T.C. Memorandum Decisions, par. 56,103). Hence, the disbursements made by the taxpayer to those noteholders

who did not formally hold certificates of stock were, under the circumstances disclosed by this record, dividends not deductible as interest under Section 23(b) of the 1939 Code as the Tax Court properly held. (R. 48, 56.)

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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FEBRUARY, 1960.

United States Court of Appeals

For the Ninth Circuit

WILBUR SECURITY COMPANY

Petitioner,

vs.

COMMISSIONER OF INTERNAL
REVENUE

Respondent.

No. 16496

REPLY BRIEF OF PETITIONER

*Appeal from the Tax Court of the
United States*

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STATEMENT

Petitioner filed a timely Petition for Review with the United States Court of Appeals for the Ninth Circuit on or about the 21st day of April, 1959, praying that the Tax Court opinion reported at 31 T.C., No. 92, be reversed. Petitioner's brief was filed and the respondent's brief in answer has been filed.

INTRODUCTION

The instant proceeding involves the question of whether certain payments made by the petitioner in the taxable years involved herein represented interest, deductible as such for federal income tax purposes, or whether such advances represented dividends which are not deducted for federal income tax purposes. The ultimate decision on this point results in a finding that petitioner either does or does not owe additional taxes for the taxable years 1953, 1954 and 1955.

The Tax Court in its opinion specified ten tests used in determining the question now before this court (Petitioner's Main Brief, pages 10 and 11). In petitioner's main brief the ten tests were discussed. The petitioner in discussing these tests, and additional tests not mentioned by the Tax Court, adequately answered all of the arguments set forth in the respondent's main brief. However, a reply brief is necessary in order to correct a number of mistakes and misstatements.

Two rather important matters have been conceded in respondent's main brief. Respondent readily admits that *form*, in the instant proceeding, points to loan rather than equity invested capital, and that the petitioner was *not inadequately capitalized* during the taxable years involved herein (Respondent's Brief, page 42). These admissions cover the main points which courts usually rely upon in making a determination of loan versus equity invested capital.

PETITIONER'S ANSWER TO RESPONDENT'S STATEMENT

Respondent on page 3 of its brief presents a statement. Respondent sets out an amendment to petitioner's by-laws adopted at a special meeting of the petitioner wherein it was set out that the stockholders of petitioner could not transfer stock without transferring \$800.00 per share of the amount outstanding in the then existing "special stockholders' account". Respondent asserts that this by-law adopted April 5, 1915, has never been amended, citing the opinion of the Tax Court (respondent's brief, page 8). This finding is clearly erroneous and is not supported by the facts of record. The said by-law covered only the accounts in the special stockholders' accounts which said account was paid off on June 5, 1939, (R. brief, p. 14). Further, John McPherson testified that this change in conditions rendered the said by-law inoperative (R. p. 173, 174). John K. McPherson testified that he did not know of the by-law until it was pointed out to him by the Internal Revenue Service in 1956 (R. 91, 92). The best evidence that

the by-law was not operative after 1939 is that several transfers of stock were made after that time without transferring the \$800.00 per share referred to in the by-laws. (R. 89, 161) .

Respondent states at page 15 of its brief, as follows: "The notes remained in the stockholder's possession at all times and none of the nonstockholders ever saw them, although some knew of them". Petitioner does not know what portion of the record supports this statement. J. K. McPherson testified that the notes were left in the possession of noteholders (R. 86). Further, the notes were kept in the vault of the State Bank of Wilbur (R. 87). There is nothing in the record to substantiate the position that the notes remained with the petitioner and that none of the stockholders ever saw them. It is true that Grace Phillips did not have the note but knew of its existence, although this is amply explained by the relationship of Mrs. Phillips to John and J. K. McPherson (R. 142).

The respondent, page 16 of brief, states as follows: "The notes executed for 1952, on December 31, 1951, were originally issued to provide for 5% interest per annum. On November 4, 1952, the Board of Directors increased this interest rate to 6%." The facts of record show that the interest rate was changed because the directors of petitioner thought the 5% interest rate was low and that the noteholders might withdraw their funds. The additional interest was an added incentive to renew the notes as they became due at the end of that year (R. p. 96, 97).

Both the Tax Court and the respondent in brief state that Grace L. Phillips was a member of the Board of Directors of petitioner from 1941 to 1955 (R. 46, R's Brief, p. 20). This erroneous assumption is not supported by the record. Petitioner J. K. McPherson testified on this point only from memory and stated that Grace Phillips was a director if "if my memory serves me right". (R 96) The fact is that Grace Phillips was not a director of the corporation during any of the taxable years involved herein. The minutes of the directors' meetings contain no reference to Grace Phillips (See Ex. 15-0 (a), 41-00, 42-pp).

PETITIONER'S ANSWER TO RESPONDENT'S SUMMARY OF ARGUMENT

In respondent's summary of argument set out at pages 22 to 26 of its brief, the respondent, at pages 24 and 25, asserts the following, in the below order, show the payments in question constituted dividends rather than interest.

1. There was in fact no fixed maturity date.
2. So called interest payments depended upon the taxpayer's earnings; the determination of whether interest would be paid and the amounts thereof was solely in the discretion of the taxpayer's Board of Directors.
3. The notes were not paid on due dates.
4. There was no attempt to enforce payment of the notes, though due dates were annually violated.
5. The advances were unsecured.

6. The notes were in fact not negotiable because they never left the taxpayer's possession.

7. Outsiders would not have made the advances under like circumstances for an indefinite length of time, in effect, subject to the risks of the business, and the return thereof being exclusively within the discretion of the taxpayer's Board of Directors.

It is inconceivable how the respondent could argue that the notes contained no fixed maturity date, (No. 1 above). The notes were all for one year and were either reissued or renewed. Certainly the fact that the advances remained with the petitioner is no indicia of maturity date. Would the respondent assert that notes had no maturity date simply because the holders thereof choose to leave the money with the corporation, beyond the original period of the loan, on a re-issuance or renewal basis. The logic of this argument seems incredible to petitioner.

The respondent argues that the interest depended upon earnings and that the payment was in the discretion of the Board of Directors (No. 2 above). The petitioner would answer this question with another question, i.e.; Who, if not the Board of Directors, in any corporation, is charged with the payment of corporate obligations?

Respondent asserts that the notes were not paid on the due dates (No. 3 above). This is dependent upon the meaning of "payment". If respondent means cash was not issued to the noteholders and loaned back, this would be a correct statement. However, it must be remembered that

the interest was paid to the noteholders annually and that new notes were issued, or the old notes renewed each year. The law should not put taxpayers to the useless act of changing money merely for the sake of formality.

The respondent asserts that there was no attempt to enforce payment of the notes though due dates were annually violated (No. 4 above). The due dates were not violated and there is no evidence in the record to substantiate this assertion of fact. The notes were re-issued or renewed each year.

The respondent next argues that the advances were unsecured (No. 5 above). The advances were not unsecured. The noteholders had every right to enforce their obligation both against petitioner and against the corporate assets and could easily have done so if demand for payment of the notes was not promptly forthcoming. There were no prior creditors of the petitioner, nor were the petitioner's noteholders ever subrogated to the rights of any individuals or corporation.

Respondent asserts too that the notes were unnegotiable since they "never left the taxpayer's possession" (No. 6 above). The evidence clearly shows that the notes were always available to the noteholders in a safety deposit box in the bank. J. K. McPherson had his note, as did his father and mother. The noteholders could have easily negotiated their notes at any time. The notes are all in evidence, and surely it could not be argued that they did not meet all of the requirements of the Negotiable Instruments Act. Further, the respondent's assertion in this regard as-

sumes that the petitioner would not give the note to the noteholder if demand for such had been made. Clearly, this assertion would not be supported by anything in the record.

The facts in evidence clearly show that the petitioner could easily have borrowed a like sum from a bank at a lower interest rate (Exhibit 28-BB), and that the chief appraiser for the Equitable Life Assurance Society of the United States would have recommended a loan to the petitioner in excess of \$500,000.00 (R. p. 112). This would dispose of petitioner's seventh argument as set forth above. In addition, the Respondent has agreed that petitioner was not inadequately capitalized in the taxable years in question (R. p. 42).

The respondent next asserts that the Tax Court was correct in not distinguishing the stockholders from the non-stockholders in determining whether the advances were contributions to capital or loans (Respondent's brief, page 25). The petitioner has covered this argument in main brief at p. 21. The Tax Court and the respondent both assert that the nonstockholders were in the same classification as preferred stockholders (R. p. 54, R's b. p. 45). This, of course, is in error. Preferred stockholders share in the increment of corporate assets and share in the distribution of those assets upon liquidation. (See American Jurisprudence, Volume 13, Para. 1378, page 1213). In the instant case, the nonstockholders would have no rights in corporate assets upon liquidation, nor share in the increment in petitioner's value. The nonstockholders had only the right to receive the

interest provided for in their notes; to collect the amount of principal at maturity date or to allow their advances to remain with the corporation if they so desired. There is no resemblance between the rights that the nonstockholders of petitioner had and rights that preferred stockholders would have in a corporation.

PETITIONER'S ANSWER TO RESPONDENT'S ARGUMENT B. 1

Respondent in brief (page 33) asserts that petitioner is relying upon *formalisms* and ignoring *substance* in the instant case. Basically, respondent urges that the only argument advanced by petitioner is that petitioner did issue notes in this case. Petitioner in its main brief relied upon much more than mere formalisms. The arguments set forth in petitioner's main brief (pages 8-23) need not be reiterated; suffice to say that respondent has failed in its brief to answer the petitioner's arguments.

It is not true, as respondent asserts (brief, page 33), that the petitioner is trying to *disguise* "the true nature of the amounts contained in the petitioner's 'bills payable account' ". It must again be reiterated that petitioner was organized in 1915 when it would have been impossible to foresee the maze of federal tax rules and regulations that it would be faced with in the taxable years involved herein. Why is it that the organizers of the petitioner as far back as 1915 characterized the amounts advanced to petitioner as loans, when there could have been no thought of the tax effect of interest versus dividends. Remember, too, that the petitioner treated the loans as such during all of

the excess profits tax years when to treat the amounts as equity invested capital would have resulted in substantial tax savings under both the World War I and World War II excess profits tax laws (R. p. 24). The respondent's use of the word "disguise" seems entirely unwarranted in the face of the facts here present.

At page 36 of its brief, respondent again asserts that the by-laws provided for an exchange of \$800.00 of the old stockholder's account with each share of stock, and that the said by-law was still "in existence during the taxable years in question". This, of course, as has been pointed out by the petitioner, is not true. The \$200,000.00 contained in the special stockholders' account up to 1938, was paid in 1938 and the stockholders' account was not in existence after that. The special stockholders' account was consolidated as respondent asserts, but the fact that money as such, did not change hands in the transaction does not cast a shadow on the consolidation (R. Brief, page 36). Here again it must be remembered that the consolidation took place at a time (1938) when federal income tax consequences were furthest from the minds of the petitioner and its officials.

The respondent at page 41 of its brief states that demands for the payment of the amounts outstanding in the petitioner's bills payable account would have caused petitioner to liquidate. This, of course, is an erroneous assumption. The record in the instant case is replete with instances where the petitioner was offered loans at least equal to the amounts outstanding in its bills payable account (see page 7 of this

brief). Further, Mr. John McPherson testified quite explicitly that petitioner could have borrowed the money to pay the amounts outstanding in the bills payable account and that petitioner was offered the money at different times to do so. (R. 170). Certainly the fact that respondent readily admits petitioner was not inadequately capitalized during the taxable years here involved is ample evidence that petitioner would not have been rendered insolvent by a payment of the bills payable account. The admission as to "adequate capitalization" (Rs. b. p. 42, 43) is also conclusive proof that the noteholders had ample security for their loans, though respondent continually states that the loans were unsecured (see R. b. p. 40). Assets of over a million and one-half dollars stood behind the notes issued by the petitioner and the notes were not subordinate to other creditors, and yet the respondent continually asserts that the amounts outstanding in the bills payable account were "unsecured". Such a statement is irreconcilable with the facts of this case.

PETITIONER'S ANSWER TO RESPONDENT'S ARGUMENT B. 2

The petitioner has pointed out in its brief and elsewhere that during most of the period here involved over 50% of the amounts outstanding in petitioner's bills payable account were loans from persons who had no stock interest in the petitioner. The Tax Court and the respondent appear to apply family attrition rules to these amounts (R. 54, 55, R's B. p. 45, 46).

The Tax Court of the United States and respondent both admit that the nonstockholders did not have the right to vote nor participate in the management, yet it is stated that the nonstockholders had the same status as preferred stockholders. Petitioner has commented upon this elsewhere in brief (see page 7). It should be reiterated, however, that the nonstockholders had no rights in the assets upon liquidation and therefore had none of the rights of a stockholder. Their rights were limited to a creditor and nothing more could be read into the notes that were held. It would seem extremely inequitable to characterize amounts as equity invested capital simply because some of the creditors were related to the stockholders. The nonstockholders had absolutely no rights beyond their recovery of the principal amount, plus interest. None of the cases relied upon by the respondent are applicable to the instant set of facts.

CONCLUSION

The petitioner was organized in 1915. It has borrowed money from its stockholders and others since that time. The amounts so borrowed have always been characterized and treated as loans. The whole factual pattern is one of *loan* rather than *equity invested capital*.

The petitioner was more than adequately capitalized in the years involved herein. Notes were issued evidencing the amount of the outstanding indebtedness and interest was paid annually to the noteholders. The noteholders of petitioner were never subordinate to other creditors and petitioner could easily have borrowed the same amount

of money from outside sources. The stockholdings and noteholdings of petitioner were in no instance pro rata. In fact, during most of the period here involved over 50% of the loans to petitioner were from individuals who owned no stock interest in the petitioner and who were not entitled to any consideration from the petitioner, save the payment of interest, plus a return of the principal amount at the maturity date of the note. On many occasions the noteholders actually withdrew the amounts outstanding in the petitioner's bills payable account.

The Internal Revenue Service in 1938 investigated the petitioner upon the same contention now before this court and even in those years in the absence of formal notes gave the petitioner a clean bill of health.

Finally, the noteholders of the petitioner intended that the amount be loans and consistently treated the same as such.

The Tax Court of the United States has erred in the instant case in their holding that the amounts outstanding in the petitioner's bills payable account represented equity invested capital and not loans. The Tax Court opinion should therefore be reversed.

Respectfully submitted,

CASTOLDI & BUTLER

By Francis J. Butler

501 Peyton Building

Spokane 1, Washington

No. 16497 ✓

United States
Court of Appeals
for the Ninth Circuit

MRS. THELMA AKANA HARRISON,

Appellant,

vs.

M. R. A., LTD., d/b/a TERRITORIAL
COLLECTORS,

Appellee.

Transcript of Record

Appeal from the Supreme Court of the
Territory of Hawaii

FILED

OCT 12 1959

PAUL P. O'BRIEN, CLERK

No. 16497

United States
Court of Appeals
for the Ninth Circuit

MRS. THELMA AKANA HARRISON,
Appellant,
vs.
M. R. A., LTD., d/b/a TERRITORIAL
COLLECTORS,
Appellee.

Transcript of Record

Appeal from the Supreme Court of the
Territory of Hawaii.

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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ATTORNEYS OF RECORD

R. G. DODGE,
602 Trustco Bldg.,
Honolulu, Hawaii,
For Appellant.

ROBERT M. ROTHWELL,
222 So. Queen St.,
Honolulu, Hawaii,
For Appellee.

In the Circuit Court of the First Judicial Circuit
Territory of Hawaii

L. No. 23326

Assumpsit

M. R. A., LTD., d/b/a TERRITORIAL COLLEC-
TORS,

Plaintiff,

vs.

MRS. THELMA AKANA HARRISON, aka MRS.
THELMA M. AKANA HARRISON, For-
merly Known as MRS. THELMA M. AKANA,
aka MRS. DAVID Y. K. AKANA, and
HAWAIIAN AMALGA PAVE, LTD.,

Defendants,

COOKE TRUST COMPANY, LIMITED, and
WILLIAM'S MORTUARY, LIMITED,

Garnishees.

COMPLAINT

To the Honorable the Presiding Judge of the Cir-
cuit Court of the First Judicial Circuit, Terri-
tory of Hawaii:

Comes now M. R. A., Ltd., d/b/a Territorial
Collectors, plaintiff above-named, and for cause of
action alleges as follows:

I.

That plaintiff is a corporation duly organized
and existing under the laws of the Territory of
Hawaii, and that defendant, Mrs. Thelma Akana

Harrison, aka Mrs. Thelma M. Akana Harrison, formerly known as Mrs. Thelma M. Akana, aka Mrs. David Y. K. Akana, is a resident of Honolulu, Hawaii, and that defendant, Hawaiian Amalga Pave, Limited, is located in Honolulu, Hawaii.

II.

That at Honolulu, T. H., on the 1st day of June, 1951, the above-named defendants made, executed and delivered to Benjamin Fukunaga a certain promissory note in writing, in words and figures as follows, to wit:

\$10,000.00

Honolulu, T. H.

June 1, 1951.

For value received, on or before the 31st day of August, 1952, the undersigned, Hawaiian Amalga-Pave, Limited, a Hawaiian corporation, and Thelma Akana Harrison, jointly and severally, promise to pay to the order of Benjamin Fukunaga, the sum of Ten Thousand Dollars (\$10,000.00), with interest thereon from date at the rate of five (5) per cent per annum, provided, however, such interest shall be waived in case this note is paid on or before the 31st day of August, 1952, as provided herein.

In case suit is brought to collect this note, or any part thereof, in undersigned, jointly and severally, promise to pay all costs of collection, including a reasonable sum as and for attorney's fee.

HAWAIIAN AMALGA-
PAVE, LIMITED,

A Hawaiian Corporation;

By /s/ THELMA AKANA HARRISON,
Its President, and

/s/ DAVID Q. GILLETTE,
Its Treasurer.

THELMA AKANA HARRISON,
THELMA AKANA HARRISON.

and thereby promised to pay to the order of said Benjamin Fukunaga the sum of \$10,000.00, as in said promissory note specified.

III.

That thereafter and prior to the bringing of this suit, said Benjamin Fukunaga for a good and valuable consideration, and by indorsement on the back of said note, duly sold and transferred said note and the money due thereon to plaintiff herein who is now the owner and holder thereof. That thereafter, and prior to the bringing of this suit, said plaintiff demanded of said defendants the payment of the sum due on said note, but defendants failed and neglected to pay the same or any part thereof; that defendants have failed, neglected and refused to pay to the damage of the plaintiff the sum of \$10,000.00 and interest thereon from August 31, 1952.

IV.

Plaintiff further believes that Cooke Trust Company, Limited, and William's Mortuary, Limited, are the attorneys, agents, factors, trustees, employ-

ers or debtors of the above-named defendants and that said garnishees have in their hands, goods or effects belonging to the said defendants, or that said garnishees are the persons from whom debts are due to said defendants, or that said garnishees are the persons from whom the said defendants are in receipt of salaries, stipends, commissions, wages, annuities or income or portions of net income under a trust.

Wherefore, plaintiff prays for judgment against defendants in and for the sum of \$10,000.00 together with interest thereon from the 31st day of August, 1952, costs and attorney's fees as provided and prays that process in due form of law issue out of this court citing and summoning defendants to appear and answer this complaint.

Plaintiff requests the court issuing summons herein to insert therein a direction to the officer serving the same to leave a true and attested copy thereof, and of this complaint with the above-named garnishees or at their usual places of abode, and to summon said garnishees to appear at the time and place in the summons appointed and then and there to disclose on oath as provided by law whether they have, or at the time said copies were served, had any of the goods, or effects of the said defendants in their hands, and if so, the nature, amount and value thereof; or whether they are, or at the time of service were indebted to the said defendants and, if so, the nature and amount of said debts; or whether the said defendants are or

at the time of service were in receipt from them of any salaries, stipends, commissions, wages, annuities or net income or portion of net income under a trust and, if so, the amounts or rates thereof.

Dated: Honolulu, T. H., this 31st day of Dec., 1953.

M. R. A., LTD., d/b/a TERRITORIAL COLLECTORS,
Plaintiff,

By PETER A. LEE &
Y. FUKUSHIMA,

By /s/ GEARON T. HAMMOND,
Attorneys for Plaintiff.

Duly verified.

[Endorsed]: Filed February 15, 1954.

[Title of Circuit Court and Cause.]

GENERAL DENIAL

Comes now Thelma Akana Harrison, one of the defendants above named, by her attorneys, Heen, Kai, Dodge & Lum, and for answer to the complaint filed herein, denies each and every, all and singular, the allegations contained therein and hereby gives notice that she will, as a complete, separate and distinct defense thereto, rely upon the fact that there was no consideration for the alleged promise as therein set forth.

Dated: Honolulu, T. H., this 19th day of April, 1954.

THELMA AKANA HARRISON,

Defendant, by

HEEN, KAI, DODGE & LUM,

By /s/ R. G. DODGE,

Her Attorneys.

Receipt of copy acknowledged.

[Endorsed]: Filed April 19, 1954.

In the Circuit Court of the First Judicial Circuit
Territory of Hawaii

L. No. 23326

M. R. A., LTD., d/b/a TERRITORIAL COLLECTORS,

Plaintiff,

vs.

MRS. THELMA AKANA HARRISON, aka MRS.
THELMA M. AKANA HARRISON, Formerly Known as MRS. THELMA M. AKANA,
aka MRS. DAVID Y. K. AKANA, and
HAWAIIAN AMALGA PAVE, LTD.,

Defendants,

COOKE TRUST COMPANY, LIMITED, and
WILLIAM'S MORTUARY, LIMITED,

Garnishees.

JUDGMENT

The issues in the above-entitled action having been regularly brought on for trial before the Honor-

able Albert M. Felix, without a jury, and the evidence adduced by the parties having been heard, and the Court having entered its Decision, Findings of Fact and Conclusions of Law, directing judgment as hereinafter provided, it is hereby

Ordered, Adjudged and Decreed that Plaintiff recover of Defendants the sum of \$10,000.00, with interest at the rate of 5% per annum from the 1st day of June, 1951, costs in the sum of \$90.25 and attorneys' fees in the sum of \$1,000.00.

Dated at Honolulu, T. H., this 7th day of March, A.D. 1957.

[Seal] /s/ P. J. O'WILLIAM, JR.,
Clerk.

Approved:

/s/ A. M. FELIX,
Judge of the Above-Entitled
Court.

[Endorsed]: Filed March 7, 1957.

In the Supreme Court of the Territory of Hawaii,
October Term, 1958

M. R. A., LTD., d/b/a TERRITORIAL COLLEC-
TORS,

vs.

MRS. THELMA AKANA HARRISON, aka MRS.
THELMA M. AKANA HARRISON, For-
merly Known as MRS. THELMA AKANA,
aka MRS. DAVID Y. K. AKANA, and
HAWAIIAN AMALGA PAVE, LTD., and
COOKE TRUST COMPANY, LIMITED, and
WILLIAM'S MORTUARY, LIMITED,

Garnishees.

No. 4046

Appeal From Circuit Court, First Circuit,
Hon. Albert M. Felix, Judge

Argued January 7, 1959.

Decided January 15, 1959.

Rice, C. J., Stainback, J., and Circuit Judge Dyer
in Place of Marumoto, J., Disqualified.

Bills and Notes—accommodation maker—liability.

One who signed a firm's note as an accommoda-
tion maker is primarily liable on the note and abso-
lutely required to pay, irrespective of consideration
to such maker. Consideration received by the co-
maker from the payee is sufficient.

OPINION OF THE COURT

By Rice, C. J.

Thelma Akana Harrison, defendant-appellant
above named, has appealed to this supreme court

from a final judgment adverse to her in the third division of the circuit court, first circuit, Territory of Hawaii, which was entered and filed on March 7, 1957, pursuant to a decision, findings of fact and conclusions of law made and filed on said date by the judge of the trial court, after a jury-waived trial.

The action was upon a promissory note, in words and figures, hereinafter quoted.

“\$10,000.00

“Honolulu, T. H.

“June 1, 1951

“For Value Received, on or before the 31st day of August, 1952, the undersigned, Hawaiian Amalga-Pave, Limited, a Hawaiian corporation, and Thelma Akana Harrison, jointly and severally, promise to pay to the order of Benjamin Fukunaga, the sum of Ten Thousand Dollars (\$10,000.00), with interest thereon from date at the rate of five (5) per cent per annum, provided, however, such interest shall be waived in case this note is paid on or before the 31st day of August, 1952, as provided herein.

“In case suit is brought to collect this note, or any part thereof, the undersigned, jointly and severally, promise to pay all costs of collection, including a reasonable sum as and for attorney’s fee.

“HAWAIIAN AMALGA-
PAVE, LIMITED,

“A Hawaiian Corporation,

“By /s/ THELMA AKANA HARRISON,

“Its President, and

“/s/ DAVID Q. GILLETTE,

“Its Treasurer.

“/s/ THELMA AKANA HARRISON,

“THELMA AKANA HARRISON”

The judgment of the trial court is: “* * * that Plaintiff recover of Defendants the sum of \$10,000.00, with interest at the rate of 5% per annum from the 1st day of June, 1951, costs in the sum of \$90.25 and attorneys’ fee in the sum of \$1,000.00.”

To the complaint in the lower court the defendant Thelma Akana Harrison had filed a general denial and had also therein given notice that she would, “* * * as a complete, separate and distinct defense thereto, rely upon the fact that there was no consideration for the alleged promise as therein set forth.” For failure to plead or otherwise defend as required by law, a default was entered against her co-defendant, the Hawaiian Amalgamated Pave, Ltd.

By stipulation entered into on behalf of the plaintiff, the defendant Thelma Akana Harrison, and Cooke Trust Company, Limited, one of the garnishees, it was provided, “* * * that in lieu of holding 3,353 shares of Nuuanu Funeral Parlor, Limited, and 4 shares of Williams Mortuary, Limited, mentioned in the Answer of said garnishee, said shares may (could) be sold and the sum of \$14,000.00 from the proceeds of sale retained by said garnishee, subject to further order of the Court * * *.” It was accordingly so ordered by

the judge of the circuit court, then having jurisdiction of the matter.

In connection with the appeal in this supreme court, briefs were submitted on behalf of Thelma Akana Harrison, defendant-appellant, and on behalf of the plaintiff-appellee, and subsequently, on January 7, 1959, oral argument was had.

That Thelma Akana Harrison signed the note as co-maker is a conceded fact, but it has been contended by her and on her behalf that she signed it as an "accommodation" co-maker; that no consideration was received by her from Benjamin Fukunaga, to whose order the note was payable; and that, therefore, as the note was transferred for collection after maturity and default by the other co-maker, she is not liable for payment of the note.

However, it has been admitted on behalf of Thelma Akana Harrison that there was consideration given by Benjamin Fukunaga to the other co-maker of the note, Hawaiian Amalga Pave, Limited.

Since the oral argument of the appeal in this case was had, this supreme court has received a copy of an advance sheet of the opinion of the United States Court of Appeals for the Ninth Circuit, in the case of James R. Yost, appellant, vs. Alberta G. Morrow, appellee, number 15,998, January 2, 1959, which we deem conclusive of the case before us.

In the cited case the note was as hereinafter quoted and set forth.

“\$7,300.00

“October 17, 1955.

“On or before April 15, 1956, after date, for value received, we promise to pay to the order of James R. Yost at the First National Bank of Portland at Nyssa, Oregon, Seven Thousand Three Hundred and 00/100 Dollars in lawful money of the United States of America, with interest thereon in like lawful money at the rate of 6 per cent per annum, from date until paid. Interest to be paid at maturity and if not so paid, the whole sum of both principal and interest to become immediately due and collectible, at the option of the holder of this note. And in case suit or action is instituted to collect this note, or any portion thereof, we promise and agree to pay, in addition to the costs and disbursements provided by statute, such additional sum, in like lawful money, as the Court may adjudge reasonable, for attorneys’ fees to be allowed in said suit or action.

“C. A. BUTCHER,

“ALBERTA G. MORROW.”

At the trial it was shown that Mrs. Morrow was the mother-in-law of Butcher, and that he lived on and managed a ranch owned by Mrs. Morrow. The latter testified that she signed the note, but that she did not receive any money from Yost. There was neither a showing nor an allegation that Mrs. Mor-

row's signature on the note was fraudulently procured.

“It further appeared at the trial that Butcher received Yost's checks in the amount of the note, and that the checks were made out to, and endorsed by, Butcher without Mrs. Morrow's signature appearing thereon.”

The note was executed in Oregon, and payment thereon was to be made in Oregon. The United States Court of Appeals for the Ninth Circuit held:

“It is settled law that under Section 24 of the Uniform Negotiable Instruments Act, adopted by Oregon in 1899, O.C.L.A. §§ 69-101 to 69-1102 (now, Oregon revised Statutes §§ 71.001 to 71.195), consideration moving to one joint maker of an instrument is sufficient to bind the other joint maker or makers. In the instant case, it is clear that Mrs. Morrow signed as an accommodation maker for her son-in-law, C. A. Butcher. It is also settled law that an accommodation maker is bound if consideration passes to the principal maker, and that the accommodation maker has primary, not secondary, liability. * * *.”

“In the instant case (Yost vs. Morrow), one co-maker, Butcher, received full consideration from Appellant. Mrs. Morrow, who was an accommodation maker, is bound on this note by reason of this consideration. The fact that (she) did not personally receive any money from Yost does not relieve her of liability on this promissory note.”

Adopted by Oregon in 1899, provisions of the uniform negotiable instruments act were adopted by the Territory of Hawaii in 1907 (Act 89, S. L. H. 1907) and have since been law in this Territory, so that what has been said in the opinion of the United States Court of Appeals for the Ninth Circuit, in *Yost vs. Morrow*, supra, as to the settled law in Oregon is likewise applicable to Hawaii. See Chapter 197, R. L. H. 1955, and like provisions in Chapter 173, R. L. H. 1945. The language of Section 197-24, R. L. H. 1955, is identical with that of Section 24 of the uniform negotiable instruments act, referred to in the opinion in said case of *Yost vs. Morrow*.

Affirmed.

/s/ PHILIP L. RICE.

/s/ INGRAM McLAIN BENT.

/s/ JOHN P. DYER.

ROBERT G. DODGE,

(HEEN, KAI, DODGE & LUM on the briefs)

For Mrs. Thelma Akana Harrison, Defendant-Appellant, and Williams Mortuary, Ltd., Garnishee.

ROBERT M. ROTHWELL,

(Also on the brief)

For Plaintiff-Appellee.

[Endorsed]: Filed January 15, 1959.

In the Supreme Court of the Territory of Hawaii
October Term, 1958

No. 4046

[Title of Cause.]

PETITION FOR REHEARING

Thelma Akana Harrison, defendant-Appellant, being aggrieved by the opinion of this court filed on January 15, 1959, affirming the judgment of the court below, presents this petition for rehearing and reconsideration of the appeal heretofore filed herein by her and, as grounds therefor, respectfully states as follows:

I.

The opinion of this court states, in part:

Since the oral argument of the appeal in this case was had, this supreme court has received a copy of an advance sheet of the opinion of the United States Court of Appeals for the Ninth Circuit, in the case of James R. Yost, appellant, vs. Alberta G. Morrow, appellee, number 15,998, January 2, 1959, which we deem conclusive of the case before us. (Op. p. 3.) (Emphasis added.)

Yost vs. Morrow is not in point and is not conclusive of the case before this court.

Following receipt of this court's opinion, defendant-appellant obtained a copy of the briefs filed in Yost vs. Morrow in the Court of Appeals. These briefs, a single copy of the appellant's Opening

Brief and a single copy of the appellee's brief, have been filed with this court as a part of this Petition.

In *Yost vs. Morrow*, the appellant was Yost, who was the payee of the note in question. Morrow was the accommodation party who had received no consideration for her promise. The following appears in the appellant's Statement of the Case (Opening Br. p. 4).

Further the Appellant testified that Mrs. Morrow was never talked to at all about the contract between Butcher (the maker) and the appellant and that all that the Appellant did was to insist that she countersigned on the note before he made the loan. (R. 60 and 61.)

The Defendant Butcher further testified that the Appellant told him that before Butcher would get his loan the Appellant had to have the note and mortgage and that he had to have Butcher's mother-in-law, Mrs. Alberta G. Morrow, sign the note. (R. 86.)

The appellee, who was successful in the trial court, defended on the ground that she was not asked to sign the mortgage and note for the purpose of lending her credit to Butcher but rather because she owned the land upon which the security for the mortgage was stored. (Op. Br. p 4; Appellee's Br. p. 3.)

The court of appeals correctly held Mrs. Morrow liable on the note for the very obvious reason that the very purpose of the accommodation—the lend-

ing of her credit to the maker and the subsequent loan made by the payee—was accomplished.

As this court well knows, the facts in the appeal before it are not in dispute that the note was given to record previous advances made by the payee to the corporate maker with no reliance whatever on the credit of the appellant, and that since the execution of the note no other person has given any value for it. These facts are set forth, by reference to the Transcript in appellant's Opening Brief pages 7-12.

Appellant restates her argument: Where all witnesses testified that the consideration for the note was the past advances made to the corporation by the payee, this court cannot manufacture or create new evidence that there was also other consideration for the note.

II.

The authorities which set forth the law applicable to accommodation parties where no value has been given for the instrument in reliance upon the credit of the accommodation party are set forth in Appellant's Opening Brief at pages 12-15.

Added authority was cited on oral argument:

Carr vs. Wainwright, 43 F2d 507, 5 Univ. of Cincinnati Law Review 115.

Brannon Negotiable Instruments, (6th Ed) p. 429.

Wherefore, your petitioner respectfully prays that this Petition for Rehearing be granted, and

specially prays that this court allow oral argument on the Petition (as provided by Rule 5 of the Rules of the Supreme Court) and that the opinion heretofore entered herein by this court be set aside and a new opinion consistent with the facts and the law be thereupon entered.

Dated: Honolulu, T. H., this 26th day of January, 1959.

/s/ R. G. DODGE,
Attorney for Defendants-
Appellants.

I certify that the foregoing Petition is presented in good faith, is well founded in law and is not for purposes of delay.

/s/ R. G. DODGE.

Receipt of copy acknowledged.

[Endorsed]: Filed January 26, 1959.

In the Supreme Court of the Territory of Hawaii,
October Term, 1958

No. 4046

[Title of Cause.]

PETITION FOR REHEARING

Filed January 26, 1959.

Decided April 6, 1959.

Rice, C. J., Stainback, J., and Circuit Judge Dyer
in Place of Marumoto, J., Disqualified.

Per Curiam.

The petition for rehearing filed herein by Thelma Akana Harrison, defendant-appellant, is denied without argument.

/s/ PHILIP L. RICE.

/s/ INGRAM McLAIN BENT.

/s/ JOHN N. DYER.

ROBERT G. DODGE,

(HEEN, KAI, DODGE & LUM)

For Mrs. Thelma Akana Harrison, Defendant-Appellant, for the Petition.

[Endorsed]: Filed April 6, 1959.

In the Supreme Court of the Territory of Hawaii

October Term, 1958

No. 4046

M. R. A., LTD., d/b/a TERRITORIAL COLLECTORS,

Plaintiff-Appellee,

vs.

MRS. THELMA AKANA HARRISON, et al.,

Defendants-Appellants,

COOKE TRUST COMPANY, LIMITED, and
WILLIAMS, MORTUARY, LIMITED,

Garnishees.

DECREE ON APPEAL

Pursuant to the opinion of this court rendered in the above cause on January 15, 1959, and the

order of this court denying a rehearing thereof entered April 6, 1959,

It Is Hereby Ordered, Adjudged and Decreed that the Judgment of the court below in the above cause be and hereby is affirmed.

Dated: Honolulu, Hawaii, May 5, 1959.

By the Court:

[Seal] /s/ LEOTI V. KRONE,
Clerk.

Approved:

/s/ PHILIP L. RICE,
Justice.

[Endorsed]: Filed May 5, 1959.

In the Supreme Court of the Territory of Hawaii
October Term, 1958

No. 4046

[Title of Cause.]

NOTICE OF APPEAL

Notice is hereby given that Mrs. Thelma Akana Harrison, one of the Defendants-Appellants above named, appeals to the Circuit Court of Appeals for the Ninth Circuit from the Judgment entered in this action May 5, 1959.

Dated: Honolulu, Hawaii, May 5, 1959.

/s/ R. G. DODGE,

Attorney for Mrs. Thelma

Akana Harrison.

HEEN, KAI & DODGE,

Of Counsel.

[Endorsed]: Filed May 5, 1959.

In the Circuit Court of the First Judicial Circuit
Territory of Hawaii

Law No. 23326

M. R. A. LTD., d/b/a TERRITORIAL
COLLECTORS,

Plaintiff,

vs.

MRS. THELMA AKANA HARRISON, aka MRS.
THELMA M. AKANA HARRISON, For-
merly Known as MRS. THELMA M. AKANA,
aka MRS. DAVID Y. K. AKANA, and
HAWAIIAN AMALGA PAVE, LTD.,

Defendants,

COOKE TRUST COMPANY, LIMITED, and
WILLIAMS MORTUARY, LIMITED,

Garnishees.

TRANSCRIPT

Of proceedings had and testimony adduced before
Honorable Albert M. Felix, Third Judge of the

above-entitled Court on February 12, February 27 and March 1, 1957.

Appearances:

GEORGE NAKAMURA, ESQ., and
Y. FUKUSHIMA, ESQ.,
Counsel for Plaintiff.

ROBERT G. DODGE, ESQ.,
Counsel for Defendant Mrs. Thelma Akana
Harrison.

* * *

BENJAMIN T. FUKUNAGA

called as an adverse witness by the defendant, being
first duly sworn, testified as follows:

Direct Examination

By Mr. Dodge:

* * *

Q. Now, you treated those as loans by yourself to the corporation, did you not, those additional expenditures that you made?

A. You could call it that.

Q. So at the time you wanted to get out you considered that the corporation owed you quite a bit of money from money that you had personally paid in promoting the business of the corporation, is that correct? A. Yes, I believe so.

Q. Had you ever evidenced those advances in any way by a corporate note prior to June 1st, 1951? A. No.

* * *

DAVID O. GILLETTE

called as a witness for and on behalf of the defendant, being first duly sworn, testified as follows:

Direct Examination

By Mr. Dodge:

* * *

The Court: Was there any mention about a note?

The Witness: The note of the corporation, yes, because they were interested in what they thought she could pay them.

The Court: The note was also discussed?

The Witness: Yes, the corporate note.

The Court: Was the note discussed?

The Witness: Yes.

The Court: Was the amount of the note discussed?

The Witness: As I recall, the figure was set at \$10,000. There wasn't any negotiation. They just said they would like a note from the corporation for \$10,000.

The Court: What for?

The Witness: Because Ben had loaned the corporation considerable money.

* * *

Q. Although you did not sign that agreement, Mr. Gillette, you did execute the note on behalf of the corporation, would you tell the Court the reason for doing so.

The Court: What note is this?

(Testimony of David O. Gillette.)

Mr. Dodge: That is the note that is being sued on.

A. Well, I knew that Mr. Fukunaga had advanced sums in excess of that amount to the corporation so I executed a note in that amount.

Q. Were you then an officer or director?

A. Well, I——

The Court: Wait. Will you explain what you mean that these were sums advanced to the corporation, this was not for the purchase of the stock?

The Witness: No, sir.

The Court: For sums advanced?

The Witness: Mr. Fukunaga had loaned the corporation monies from time to time, which was far in excess of that amount.

The Court: And the company felt that they owed him this money?

The Witness: Well, the company actually owed him a lot more money, but they thought it would be easier to sell the company if it didn't owe so much so apparently they came to some decision and made it \$10,000.

The Court: So when you signed this note it was for sums advanced?

The Witness: Yes, sir.

The Court: And Hawaiian Amalga Pave Company was to repay Mr. Fukunaga for sums advanced in the amount of \$10,000?

The Witness: Yes, sir.

The Court: And this had nothing to do with the purchase of the stock?

(Testimony of David O. Gillette.)

The Witness: No, sir.

* * *

Mr. Nakamura: I beg to differ slightly with the defendant. If the Court will recall, the plaintiff's proof was very brief, based merely on stipulations and the admission of the note in evidence. The note shows on its face, and on the face of the agreement, that it is a note signed by the corporation with Thelma Akana Harrison as accommodation co-maker. Now, the question of whether there is a sale involved, or not a sale, or an agency, is not part of the plaintiff's case. That is something that has been brought up by the defendant. Now we contend, your Honor, that surely, even under the negotiable instruments law, and whatever is derived from this agreement and from the testimony, that insofar as the corporation is concerned there was more than sufficient consideration for the execution of the note, in that the note was executed in extinguishment of the existing debts which had existed between the corporation and Ben Fukunaga, the advances that he had made on behalf of the corporation, and antecedent debts under our law is valuable consideration, and, therefore, Ben Fukunaga is without doubt a holder for value. Now, insofar as Thelma Akana Harrison is concerned, I think Mr. Dodge has been contending all along also, he has been showing that Thelma Akana Harrison is an accommodation co-maker. Am I right, Mr. Dodge?

Mr. Dodge: Certainly.

Mr. Nakamura: And under the law, your Honor, even under the negotiable instruments law there need not be any consideration moving directly to an accommodation co-maker.

The Court: Mr. Dodge doesn't agree with you.

Mr. Dodge: I don't agree with him.

The Court: That is a question of law.

* * *

ASSOCIATE JUSTICE MASAJI MARUMOTO called as a witness, on rebuttal, for and on behalf of the plaintiff, being first duly sworn, testified as follows:

* * *

Cross-Examination

By Mr. Dodge:

* * *

Q. Now, this corporation note then represented, did it not, the amount that the corporation was obligated to Mr. Fukunaga?

A. That is in theory, that note was, that it represented the corporate obligation to Mr. Fukunaga.

Q. And that corporate obligation is the sum that you have testified, the corporation obligation of \$8,890?

The Court: What about the stock?

Q. Isn't that correct?

A. Plus the loss, whatever there is, on the Hawaiian Amalga Pave claim against Standard Steel.

(Testimony of Masaji Marumoto.)

The Court: You haven't answered this question, what about the stock?

Mr. Dodge: Your Honor, may I please present this in an orderly fashion? It is necessary for me to do it to present it. This is a very confusing situation——

The Court: There is nothing confusing about this.

Mr. Dodge: Apparently the Court appears to be confused on it, your Honor.

The Court: You are trying to say that is the only corporate obligation——

Mr. Dodge: I am not trying to say anything. I am just trying to find out from Mr. Marumoto, who drew the agreement, what the agreement does.

Q. Isn't it correct that the only corporate obligation on June 1st to Mr. Fukunaga was the sum of \$8,890?

A. Let me see, the National Amalga Pave of \$7,090, and the lease—I am thinking of Standard Steel Corporation.

Q. That was treated separately, wasn't it?

A. It was treated separately, yes.

Q. By an assignment?

A. That is right, but there would have been a loss incurred because Standard Steel I think was willing to refund only \$2,300, or some such sum, and so there would have been an enormous sum of loss there which Mr. Fukunaga expended for Hawaiian Amalga Pave.

(Testimony of Masaji Marumoto.)

Q. That was a loss, was it not, that he was well aware of even in his letter of May 9?

A. Beg your pardon.

Q. He was aware of that loss in his letter of May 9? A. Still there was that loss, yes.

Q. He acknowledged the fact that he had paid that amount and he knew that he would only be able to recover a certain amount of it?

A. Still that would be a claim against the corporation.

Q. All right. That claim was all included in this assignment of whatever rights he had?

A. All right. Now, he had put out \$9,000 to Standard Steel. Now, according to this agreement, at that time there was an offer by Standard Steel to refund Mr. Fukunaga the sum of \$3,423.00, and then also an agreement to give a credit of \$2,500 if an Amalga Pave unit was later ordered. That adds up to the sum of \$5,923 and that would still leave Mr. Benjamin Fukunaga \$3,077 out of pocket, which brings it up to beyond \$10,000.

Q. About eleven thousand, possibly twelve thousand? A. That is right.

Q. Those were the only corporate obligations that were—— A. I suppose so.

The Court: All right. Let's stop right there. That was the only corporate obligation, Judge?

The Witness: I think so.

The Court: How about the stock, isn't that a corporate obligation?

(Testimony of Masaji Marumoto.)

The Witness: That is not a corporate obligation. That is an individual obligation of Thelma Akana.

The Court: How about the stock that is held by the individual stockholders, is that a corporation obligation?

The Witness: That is not a corporate obligation.

The Court: What is it?

The Witness: Because the agreement was——

The Court: What is it? Let's forget about this agreement. What is it?

The Witness: It is an obligation of Thelma Akana.

The Court: Does the corporation owe the stockholders the value of the stock?

The Witness: The corporation does not owe the stockholders—let me see now—let me see what your question would be, your Honor.

The Court: You said that the only corporation obligation is this \$8,890.

The Witness: Plus the \$3,077.

The Court: That is what I am asking you. Is there any other corporate obligation? What about the stock?

The Witness: The stock is an obligation of Thelma Akana because Thelma Akana——

The Court: Let's forget about Thelma Akana. Let's talk about this corporation.

The Witness: The corporation did not agree to repurchase the shares, so the obligation of the corporation is not on the stock.

Q. (By Mr. Dodge): As a matter of fact, Mr.

(Testimony of Masaji Marumoto.)

Marumoto, the corporation could not have purchased these shares of stock——

A. That is correct.

Q. ——under the laws of the Territory?

A. That is correct.

* * *

Q. (By Mr. Dodge): You stated in your direct testimony, Mr. Marumoto, that it was your understanding of this agreement of June 1, that Ben would cancel the obligation the corporation had to him other than those taken up in the note, and we have already identified what that other obligation might have been, \$1,967.

A. \$11,967, Mr. Dodge.

Q. You had a corporation note for that?

A. Of which \$10,000 was represented by this new corporate note.

Q. So he forgave the corporation a maximum of \$1,967 of its debts?

A. All right.

Q. But you also stated that Mrs. Harrison also was forgiven other claims that Mr. Fukunaga had against her personally, do you recall that testimony?

A. Well, if there was any, sure.

Q. Well, you stated——

A. Well, the \$10,000 was the complete settlement.

Q. ——“As far as I know the nature of the agreement was that she was to pay \$10,000 on August 31, 1952, and that whatever other claim that Mr. Benjamin Fukunaga had against her, or against Hawaiian Amalga-Pave, would be waived.”

A. That's right.

(Testimony of Masaji Marumoto.)

Q. Were you aware of any claim that Mr. Fukunaga had against her on June 1st, 1951?

A. I am not aware, no.

Q. And this \$1,967 is the only other claim that you can think of that the corporation had against Ben, or that Ben had against the corporation?

A. That is he waived the \$11,967—

Q. And got a corporation note?

A. Yes, for that \$10,000.

Q. Do you know whether or not Mr. Peter Fukunaga had any claim against Mrs. Harrison?

A. No.

Q. Do you know whether or not he claimed that he did? A. I don't think he did.

* * *

[Endorsed]: Filed September 25, 1957.

DEFENDANT'S EXHIBIT A

This Agreement made and entered into this 1st day of June, 1951, by and between Thelma Akana Harrison, party of the first part, hereinafter called Harrison, and Benjamin T. Fukunaga, party of the second part, hereinafter called Fukunaga,

Witnesseth:

1. That in consideration of the sum of \$1.00 to him paid by Harrison, the receipt of which is

hereby acknowledged, and the agreements of Harrison hereinafter contained, Fukunaga hereby agrees with Harrison as follows:

(a) That he will assign and transfer to Harrison 7,500 shares of the capital stock of Hawaiian Amalga-Pave, Limited, of the par value of \$10.00 per share;

(b) That he will pay all telephone and radio-gram bills incurred on behalf of Hawaiian Amalga-Pave, Limited, by him since January 15, 1951, to the date hereof;

(c) That he will indemnify Hawaiian Amalga-Pave, Limited, and save it harmless from any and all claims on account of the moneys obtained by him in connection with the proposed sale by him of the shares of the capital stock of Hawaiian Amalga-Pave, Limited, and in this connection he will make, within a reasonable time from date, all arrangements for the repayment of all such sums obtained by him; and

(d) That upon the delivery to him of:

(i) Promissory note made by Hawaiian Amalga-Pave, Limited, as maker, and Harrison as accommodation co-maker, in the sum of \$10,000.00, as hereinafter provided;

(ii) Assignment of all rights of Hawaiian Amalga-Pave, Limited, against Standard Steel Corporation in connection with the deposit in the sum

of \$9,000.00 made on a purchase order for an amalga-pave plant, as hereinafter provided; and

(iii) Check covering the credit balance in the account of Hawaiian Amalga-Pave, Limited, with the Liberty Bank of Honolulu,

he will waive and cancel any and all claims that he has against Hawaiian Amalga-Pave, Limited, except the claim on the promissory note hereinabove mentioned, and will also cancel the agreement with Harrison, dated October 17, 1950, including the option given to Fukunaga by Harrison to purchase the shares of the capital stock of National Amalga-Pave, Inc., owned by Harrison, as provided in paragraph 8 of said agreement, and the option given to Fukunaga by Harrison to obtain a sub-license from National Amalga-Pave, Inc., to use and practice the invention patented under United States Patent No. 2,220,670 in Japan, as provided in paragraph 9 of said agreement.

2. In consideration of the foregoing agreement of Fukunaga, Harrison hereby agrees with Fukunaga as follows:

(a) That upon the assignment and transfer by Fukunaga to her of 7,500 shares of the capital stock of Hawaiian Amalga-Pave, Limited, of the par value of \$10.00 per share, she will cause Hawaiian Amalga-Pave, Limited, to:

(i) Execute and deliver to Fukunaga a promissory note for \$10,000.00, payable on or before

August 31, 1952, providing for interest from date at the rate of 5% per annum and waiver of interest in case of payment on or before August 31, 1952, and also providing for payment of all costs of collection including a reasonable attorney's fee in case of default, and Harrison will join in the execution of said promissory note as accommodation co-maker;

(ii) Accept the offer made by Standard Steel Corporation, in connection with the deposit in the sum of \$9,000.00 made on a purchase order for an amalga-pave plant, to refund the sum of \$3,423.00 immediately and to allow a credit of \$2,500.00 on the purchase of an amalga-pave plant within six months from May 11, 1951, as contained in its letter of said date, and to assign to Fukunaga all rights to said refund of \$3,423.00 and credit of \$2,500.00; and

(iii) Issue a check covering the credit balance in the account of Hawaiian Amalga-Pave, Limited, with The Liberty Bank of Honolulu.

(b) That in the event that Harrison shall sell said 7,500 shares of the capital stock of Hawaiian Amalga-Pave, Limited, prior to August 31, 1952, she will specify as a condition of such sale that the purchaser of such shares shall loan the sum of \$10,000.00 to Hawaiian Amalga-Pave, Limited, and cause Hawaiian Amalga-Pave, Limited, to pay the above-described promissory note immediately upon receipt of such loan.

In Witness Whereof, the parties hereto have executed this agreement the day and year first above written.

/s/ THELMA AKANA HARRISON.

/s/ BENJAMIN T. FUKUNAGA.

[Endorsed]: Filed September 25, 1957.

DEFENDANT'S EXHIBIT E

Honolulu, T. H.

May 9, 1951

Mrs. Thelma Akana Harrison

Honolulu, T. H.

Dear Mrs. Harrison:

In connection with Hawaiian Amalga-Pave, Limited, I have thus far paid out the sum of \$29,-240.42, exclusive of sundry promotional expenses, as follows:

Paid to you, October 17, 1950.....	\$10,000.00
Paid to National Amalga-Pave, Inc., according to your direction, January 18, 1951	7,090.92
Paid to you, October 17, 1950, for the shares of David Gillette, Gersham Martin and Raymond Akana.....	1,350.00
Paid to Chester Clarke, as rental, June, 1950. to February, 1951.....	1,800.00

Down payment to Standard Steel Corporation for Amalga-Pave unit.....	9,000.00
	<hr/>
	\$29,240.92

You have delivered to me two stock certificates of Hawaiian Amalga-Pave, Limited, for 30,000 shares of its common stock, one being for 16,500 shares previously owned by you and the other being for 13,500 shares previously owned by David Gillette, Gersham Martin and Raymond Akana.

I have decided to dispose of any interest that I may have in Hawaiian Amalga-Pave, Limited, and submit to you the following proposition:

1. I will endorse and deliver to you the certificates for 30,000 shares of common stock of Hawaiian Amalga-Pave, Limited, which are now in my name.

2. In consideration of the delivery of the stock certificates to you:

- (a) You will execute and deliver to me your promissory note for \$10,500.00, payable on or before October 31, 1951. Your promissory note to me dated October 17, 1950, will be returned to you, marked "cancelled." That note carried interest at the rate of 5% from October 17, 1950. In case you pay the new note on or before October 31, 1951, I will deduct the sum of \$500.00 and you need pay me the sum of \$10,000.00 only.

- (b) You will cause Hawaiian Amalga-Pave, Limited, to assign to me all of its claim against

Standard Steel Corporation for the return of the \$9,000.00 deposited in connection with the order for an amalga-pave unit ordered in the name of Hawaiian Amalga-Pave, Limited. I will negotiate with Standard Steel Corporation for the recovery of such deposit, or any part thereof.

3. With reference to the following:

\$1,350.00 paid for the shares of David Gillette, Gersham Martin and Raymond Akana;

\$1,800.00 paid to Chester Clarke as rental for June, 1950, to February, 1951; and

\$7,090.92 paid to National Amalga-Pave, Inc., at your request,

I request that you reimburse said sums to me in case you sell the shares of Hawaiian Amalga-Pave, Limited, for a sum in excess of \$10,000.00. For instance, if you sell the shares for \$20,240.92, you will reimburse me \$10,240.22, being the total of the three items mentioned above. But if you sell the shares for less than \$20,240.92, then you will reimburse me any sum that you obtain in excess of \$10,000.00. On these items, I will depend solely on your good faith to enable me to recover as much of my cash outlay as possible. Also, I request that you immediately cause to be withdrawn from The Liberty Bank of Honolulu the sum of \$423.55 in the account of Hawaiian Amalga-Pave, Limited, and apply the same in partial reimbursement of the items mentioned herein. In case you do not sell the shares but retain them, then you shall reimburse all of said

sums to me when Hawaiian Amalga-Pave, Limited, starts the manufacture of amalga-pave.

Also with reference to the deposit of \$2,600.00 for the amalga-pave unit, if you know of any person who is interested in taking over the contract for the purchase of the unit so that my loss will be minimized, I request you refer any such person to me. Here again, I request no more than your good faith in helping me to minimize my loss.

Yours very truly,

/s/ BENJAMIN FUKUNAGA.

[Endorsed]: Filed September 25, 1957.

DEFENDANT'S EXHIBIT F

May 25th, 1951.

Mr. Benjamin Fukunaga,
Honolulu, T. H.

Dear Mr. Fukunaga:

I have your letter of May 9th, 1951, on hand.

You realize, I am sure, that according to our contract dated October 17, 1950, that when you took up the option stated in Article VI thereof that my note to you in the amount of \$10,000.00 was automatically cancelled.

Because I am desirous of assisting you to dispose of your interest in Hawaiian Amalga-Pave, Limited, in the hope that you can recover a part of your in-

vestment I suggest that the following be agreed to before I can act further:

1. That you agree to sell your 30,000 shares which we understand is the total outstanding stock at this date for a certain fixed price.
2. That the option regarding the purchase of \$10,000.00 of shares of National Amalga-Pave, Inc., at par value held by me be cancelled.
3. That the option regarding the sub-license for Japan be cancelled.

Since you have carried on the negotiations with Standard Steel Corporation yourself, I feel it is better that you continue to negotiate this settlement. Had you not cancelled the plant, I could have assisted you in minimizing the loss thereon by transfer of your paid-up interest therein to one of the licensees of National Amalga-Pave, Inc. However, Standard Steel Corporation has advised National Amalga-Pave, Inc., that you have cancelled the order thereby stopping production of your unit which leaves nothing to sell at this time. I am sorry you took such action before advising me of the same for it now prevents me from helping you in this matter.

As soon as the sales price for Hawaiian Amalga-Pave, Limited, is set please advise me so that I may take immediate action to dispose of it for you.

The fact that I am not morally or financially obligated to do this for you but have offered to do it indicates my good faith.

Very truly yours,

THELMA AKANA HARRISON.

TAH:ip

[Endorsed]: Filed September 25, 1957.

In the Supreme Court of the Territory of Hawaii,
October Term, 1958

No. 4046

(L. No. 23326)

[Title of Cause.]

SUPREME COURT CLERK'S CERTIFICATE
TO CERTIFIED TRANSCRIPT OF REC-
ORD ON APPEAL TO 9 CCA

I, Leoti V. Krone, deputy clerk of the above-entitled court, hereby certify that all of the documents listed in the Designation of Record on Appeal to the United States Court of Appeals for the Ninth Circuit are the original documents and items filed in the above-entitled court and cause, and that all of said documents and items are attached hereto.

In Witness Whereof, I have hereunto set my hand and affixed the seal of the above court this 8th day of June, 1959.

[Seal] /s/ LEOTI V. KRONE,
Clerk.

United States Court of Appeals
Ninth Circuit

No. 16497

MRS. THELMA R. HARRISON,

Appellant,

vs.

M. R. A., LTD., d/b/a TERRITORIAL
COLLECTORS,

Appellee.

STATEMENT OF POINTS TO BE
RELIED UPON ON APPEAL

1. The Supreme Court of Hawaii erred in deciding that an accommodation party to a negotiable instrument is liable to a holder, other than a holder in due course, when the accommodation party received no consideration for her promise and when no person gave value for the note in reliance upon the credit of the accommodation party.

2. The Supreme Court of Hawaii erred in deciding that the case of Yost vs. Morrow (CCA 9th, No. 15,998, decided January 2, 1959) was conclusive of the instant case, it being clear that in Yost vs. Morrow the payee of the note had relied upon the credit of the accommodation party before giving value to the maker whereas in the instant case it is clear that the note was given to record previous advances by the payee to the corporate maker, and not in any way in reliance upon the credit of the accommodation party.

Dated: Honolulu, Hawaii, this 1st day of July, 1959.

/s/ R. G. DODGE,
Attorney for Appellant.

Receipt of copy acknowledged.

[Endorsed]: Filed July 8, 1959.

[Endorsed]: No. 16497. United States Court of Appeals for the Ninth Circuit. Mrs. Thelma Akana Harrison, Appellant, vs. M. R. A., Ltd., d/b/a Territorial Collectors, Appellee. Transcript of Record. Appeal from the Supreme Court of the Territory of Hawaii.

Filed and docketed: June 10, 1959.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for
the Ninth Circuit.

IN THE
United States Court of Appeals
FOR THE NINTH CIRCUIT

PACIFIC NATURAL GAS Co.,
a corporation,

Petitioner,

vs.

FEDERAL POWER COMMISSION,

Respondent.

✓
No. 16498

OPENING BRIEF OF PETITIONER

Upon Review of Order of Federal Power Commission

PRESTON, THORGRIMSON & HOROWITZ
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Attorneys for Petitioner.



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Attorneys for Petitioner.



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IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

PACIFIC NATURAL GAS CO.,
a corporation,

Petitioner,

vs.

FEDERAL POWER COMMISSION,

Respondent.

No. 16498

OPENING BRIEF OF PETITIONER

Upon Review of Order of Federal Power Commission

JURISDICTION

This is a proceeding to review an order of the Federal Power Commission. This court has jurisdiction under the provisions of Section 19(b) of the Natural Gas Act, 15 USCA §717r(b), 52 Stat. 831. The order under review was issued by the Federal Power Commission February 25, 1959 (R. 1372-4). Petitioner herein filed a motion for reconsideration, constituting a motion for rehearing, on March 18, 1959 (R. 1375-7). On June 12, 1959 Petitioner filed its petition for review in this court.

STATEMENT OF THE CASE

Identification of Parties

Pacific Natural Gas Company, Petitioner herein, is a public utility company engaged in the business of purchasing, distributing and selling natural gas in the State of Washington. The natural gas so purchased has been and is being purchased from Pacific Northwest Pipeline Corporation, an intervenor herein, it having the only available source of supply. Pacific Northwest Pipeline Corporation, hereinafter referred to for convenience as "Pipeline Corporation," is a "natural-gas company" as that term is defined in the Natural Gas Act, 15 USCA §717a(6), 52 Stat. 821. The sales by Pipeline Corporation to Petitioner are "jurisdictional" sales, in the sense that they are sales to which the provisions of the Natural Gas Act are made applicable by Section 1(b) thereof, 15 USCA §717(b), 52 Stat. 821. The Commission charged with the administration of the Act is the Federal Power Commission.

The pertinent provisions of the Natural Gas Act, 15 USCA §717, *et seq.*, referred to as the "Act," are set out in Appendix A, *infra*.

Questions Involved

There are two methods by which rate changes may be accomplished under the Act, the first under the provisions of Section 4(d) and (e), and the other under Section 5(a).

Section 4(d) provides that no change shall be made in an existing rate except after 30 days' notice to the Commission, to be given by filing new schedules showing the changes.

Section 4(e) authorizes the Commission upon complaint or its own initiative, upon reasonable notice, to enter upon hearing concerning the lawfulness of such noticed rate; to suspend the rate for a period no longer than five months beyond the time when it would otherwise go into effect:

“ . . . *Provided*, That the Commission shall not have authority to suspend the rate, charge, classification, or service for the sale of natural gas for resale for industrial use only; . . . ”

and, if the proceeding has not been concluded and an order made at the expiration of the suspension period, to require a bond or undertaking from the natural-gas company conditioned to refund with interest any portion of the increased rates ultimately found not justified, as a condition to their becoming effective.

Section 5(a) provides that whenever the Commission after hearing had upon its own motion or upon complaint shall find that any rate is unreasonable, unjust or unduly discriminatory, the Commission shall determine the just and reasonable rate to be thereafter observed, and shall fix the same by order.

The questions involved in this review stem from the *proviso* in Section 4(e) which denies to the Commission authority to suspend rate increases for the sale

of natural gas for resale for industrial use only. For convenience such gas will be herein referred to as "industrial gas."

The first question is whether a contract between a natural-gas company and its distributor customer which provides that the natural-gas company may file rate changes under Section 4 of the Natural Gas Act, and also expressly provides that such customer shall have the right to protest any such rate changes before the Federal Power Commission, gives consent to the unilateral filing under Section 4(d) of increased rates for natural gas sold for resale for industrial use only. It is our contention that under such a contract the natural-gas company bargained away its right to file unilateral rate increases for industrial gas under Section 4(d), because the provisions of Section 4(e) deny to the distributor any right to make effective protest of the rate increase before the Federal Power Commission.

The second question presented is whether Section 4(d) and (e) of the Natural Gas Act when applied to a unilateral filing thereunder by a natural-gas company of increased rates for natural gas sold for resale for industrial use only meets the due process requirements of the Fifth Amendment to the Constitution of the United States.

It is our contention that because Section 4(e) makes no provision for suspension, interim refund or award of reparation of any rate increase so filed which is ultimately held to be unjust, unreasonable or discriminatory,

and therefore unlawful, this statutory deficiency permits Petitioner to be deprived of its property without due process of law and without just compensation, contrary to the Fifth Amendment. It is our further contention that not only does the Act foreclose any right of suspension, interim refund or award of reparations by the Commission, but it also deprives Petitioner of its right by court action to recover amounts paid under rates ultimately held by the Commission to be unlawful.

Petitioner's Contract with Pipeline Corporation

Petitioner entered into an agreement with Pipeline Corporation dated May 3, 1957 and designated by Pipeline Corporation as its PNW Contract No. 65, which contract covered the sale by Pipeline Corporation to Petitioner and the purchase by Petitioner from Pipeline Corporation of industrial interruptible gas only (R. 1067-71). The contract provided that Petitioner should pay to Pipeline Corporation for natural gas service rendered under the agreement in accordance with Pipeline Corporation's Rate Schedule I-1 as filed with the Federal Power Commission and as such rate schedule may be amended or superseded from time to time. That rate schedule, a copy of which was attached to the contract, provided for a rate of 2.5c per therm. Article III of the contract providing for this rate schedule reads as follows:

“ARTICLE III—APPLICABLE RATE SCHEDULE

“Buyer agrees to pay Seller for all natural gas service rendered under the terms of this Agreement in accordance with Seller’s Rate Schedule I-1 as filed with the Federal Power Commission, and as such rate schedule may be amended or superseded from time to time. This Agreement shall be subject to the provisions of such rate schedule and the General Terms and Conditions applicable thereto on file with the Federal Power Commission and effective from time to time, which by this reference are incorporated herein and made a part hereof.”

Paragraph 10 of the General Terms and Conditions referred to in the above quoted paragraph provides as follows:

“10. STATUTORY REGULATION

“Seller’s rates, charges, classifications and services as set forth in this Tariff are subject to regulation by the Federal Power Commission under the Natural Gas Act. Seller shall have the right to file from time to time with the Federal Power Commission under Section 4 of the Natural Gas Act such new rate schedules and changes in its existing effective Tariff as Seller may find necessary from time to time to assure Seller just and reasonable rates and charges as well as a rate of return sufficient to service the Seller’s debt, attract capital, insure expansion and provide adequate natural gas service to all Seller’s customers. Without in any way limiting the generality of the foregoing, Seller shall have the right to file new rate schedules fairly and appropriately reflecting changes in the rates and charges paid by Seller for natural gas. Buyer shall have the right to protest any such new rate schedules and changes before the Federal Power Commission.”

Proceedings Before the Commission

On August 6, 1957 Pipeline Corporation filed with the Commission schedules covering a general increase in its rates (R. 434-687). Included was Second Revised Sheet No. 14, increasing the rate for industrial gas to 2.86c per therm. This filing was docketed by the Commission under Docket No. G-13202, and by order entered September 4, 1957 (R. 817) all of the filings except First Revised Sheet No. 15 and Second Revised Sheet No. 14 were suspended to February 5, 1958, and until such further time as they may be made effective in the manner prescribed by the Natural Gas Act.

By order entered October 31, 1957 (R. 987) Petitioner was granted intervention in Docket No. G-13202, and on January 17, 1958 it moved for an order rejecting the filing of the revised tariff sheets applicable to it, including Second Revised Sheet No. 14 (R. 1061-76).

On February 25, 1959 this motion to reject was summarily denied, without hearing or argument (R. 1372-4). On March 18, 1959 Petitioner filed a motion for reconsideration of the order entered February 25, 1959 denying its motion to reject the filing of rate increases (R. 1375-93). No action was taken by the Commission with respect to this motion until July 23, 1959, when it entered an order denying the motion, again without hearing or argument of any kind (R. 1409-12). In the meantime, and on June 12, 1959, more than 30 days having expired without the Commission having acted upon the motion, Petitioner filed with this court its petition for review.

SPECIFICATION OF ERRORS

1. The Commission erred in denying Petitioner's motion to reject the filing of Pacific Northwest Pipeline Corporation's Second Revised Sheet No. 14, filed August 6, 1957, to become effective September 5, 1957, increasing rates for industrial gas from 2.5c to 2.86c per therm.

2. The Commission erred in denying Petitioner's motion for reconsideration of the foregoing order.

ARGUMENT

I

By Granting Petitioner the Right to Protest Rate Increases Before the Federal Power Commission, Pipeline Corporation Bargained Away its Right to Unilaterally File Increased Rates for Industrial Gas Under Section 4 of the Act

For convenience we again set forth Paragraph 10, which was incorporated into the agreement of May 3, 1957 by reference:

“10. STATUTORY REGULATION

“Seller's rates, charges, classifications and services as set forth in this Tariff are subject to regulation by the Federal Power Commission under the Natural Gas Act. Seller shall have the right to file from time to time with the Federal Power Commission under Section 4 of the Natural Gas Act such new rate schedules and changes in its existing effective Tariff as Seller may find necessary from time to time to assure Seller just and reasonable rates and charges as well as a rate of return sufficient to service the Seller's debt, attract capital,

insure expansion and provide adequate natural gas service to all Seller's customers. Without in any way limiting the generality of the foregoing, Seller shall have the right to file new rate schedules fairly and appropriately reflecting changes in the rates and charges paid by Seller for natural gas. Buyer shall have the right to protest any such new rate schedules and changes before the Federal Power Commission."

It will be noted that the second sentence of this paragraph does not give Pipeline Corporation an express, unqualified right to file new rate schedules and changes under Section 4 of the Natural Gas Act. The right is by language limited to such as seller may find necessary from time to time to assure it of rates sufficient to cover many things, in addition to and not necessarily ingredients of just and reasonable rates. The standard that these may be such as the seller find necessary from time to time creates wholly a subjective standard. Probably the effect, if the second and third sentences stood alone, would not be different legally than if the right had been unqualified. The rates fixed would be at the will of Pipeline Corporation. Nor would they be "going" rates, because Pipeline Corporation could with impunity file discriminatory and nonuniform schedules. Any rate Pipeline Corporation chose to file for industrial gas under Section 4(d) would by the mandatory terms of Section 4(e) become effective in 30 days, without consent or any other action on the part of the Commission, and without any power of suspension, interim refund or reparation, no matter how unjust, unreasonable or discriminatory the filed rates might be.

This brings us to a consideration of the meaning of the last sentence of Paragraph 10, which reserves to Petitioner the right to protest any such new rate schedules and changes before the Federal Power Commission. It must be agreed that this provision was intended to grant a real and substantial right of protest. This must mean a protest which, if the proposed increased rates or charges are unjust and unreasonable, would avoid their effective imposition. As used in a contract of this kind, it must embrace the conception of an opportunity to be heard before the Federal Power Commission in a proceeding adapted to the end sought to be accomplished. Any other conception would nullify the right granted. As to rates for other than industrial gas, we concede that the statutory provisions of Section 4 with respect to suspension and refund as construed and applied by the Commission substantially assure this right. But as to rates for industrial gas, they become effective without any act or consent of the Commission, and the Commission is wholly without power to suspend them or to preserve a right to interim refund if at some indeterminate time in the future they are found to have been unjust, unreasonable or discriminatory, and therefore unlawful.

To make the last sentence of Paragraph 10 meaningful it must be held that the express consent to file under Section 4 given in the second sentence of the paragraph is by necessary implication limited to filings other than those relating to industrial gas, in the absence of consent to the specific rate filed. Schedules amending or superseding Schedule I-1, the rate for industrial

interruptible gas referred to in Article III of the contract, must necessarily mean and be limited to schedules expressly consented to by Petitioner or resulting from proceedings under Section 5(a) of the Act. Only by so construing the whole contract will the integrity of the last sentence of Paragraph 10 be preserved.

This construction of the contract is given support by further consideration of the legal effect of the second and third sentences of Paragraph 10 if they were to apply to rates for industrial gas. As applied to rates for such gas, it must be held that they would make the price conditioned entirely on the will of the Pipeline Corporation. A contract for the future delivery of personalty cannot be enforced if the price of the article to be delivered is conditioned entirely on the will of one of the parties. 77 C.J.S. 623, §21b; *Taller & Cooper v. Illuminating Electric Co.*, 172 F.(2d) 625, 626; *Washington Chocolate Co. v. Canterbury Candy Makers, Inc.*, 18 Wn.(2d) 79, 85, 138 P.(2d) 195. Application of this rule would invalidate the provisions of the contract relating to change of price for industrial gas and leave the named rate fixed in the contract in effect, thus bringing the case within the rule of *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332, 100 L.Ed. 373. In that case the Supreme Court held that the right of the natural-gas company to change its rates for sales made pursuant to contract is defined by the terms of the contract, and, absent contractual consent, Section 4(d) of the Natural Gas Act gave no right to increase the contract rate by a filing thereunder.

II

To Permit the Unilateral Filing of Rates for Industrial Gas by Pipeline Corporation Under Section 4(d) of the Natural Gas Act Will Permit the Taking of Petitioner's Property Without Due Process of Law, Contrary to the Fifth Amendment to the Constitution of the United States.

In its order issued September 4, 1957 in Docket No. G-13202 (R. 817-9) the Commission stated in the first paragraph:

“Pacific Northwest Pipeline Corporation (Pacific), on August 6, 1957, tendered for filing First Revised Sheet Nos. 4, 7, 10, 15, 16-C, and 16-E; Section Revised Sheet Nos. 6, 8, 9, 11, 12, 13, 14, and 20; and Original Sheet No. 20-A to its FPC Gas Tariff, Original Volume No. 1. Said tendered sheets are intended to be made effective on September 5, 1957, and propose an annual increase in rates and charges for jurisdictional sales amounting to approximately \$5,500,000, based on estimated 1957 sales volumes. The proposed increase is 17 per cent over the rates and charges now being collected by Pacific.”

After reference to certain protests made and to certain of the questionable items included in the increased rates, the order then provides:

“The increased rates and charges provided in said tariff sheets, as tendered on August 6, 1957, have not been shown to be justified, and may be unjust, unreasonable, unduly discriminatory, or preferential, or otherwise unlawful.

“The aforesaid First Revised Sheet No. 15 and Second Revised Sheet No. 14 to Pacific's FPC Gas

Tariff, Original Volume No. 1, provide for the sale of natural gas for resale to industrial customers.

“The Commission finds:

“It is necessary and proper in the public interest, and to aid in the enforcement of the provisions of the Natural Gas Act, that the Commission enter upon a hearing concerning the lawfulness of the rates, charges, classifications, and services contained in Pacific’s FPC Gas Tariff, Original Volume No. 1, as proposed to be changed by the tariff sheets tendered on August 6, 1957; and that the aforesaid First Revised Sheet Nos. 4, 7, 10, 16-C, and 16-E; Second Revised Sheet Nos. 6, 8, 9, 11, 12, 13, and 20; and Original Sheet No. 20-A to Pacific’s FPC Gas Tariff, Original Volume No. 1, be suspended and the use thereof deferred as hereinafter ordered.

“The Commission orders:

“(A) Pursuant to the authority of the Natural Gas Act, particularly Sections 4 and 15 thereof, the Commission’s Rules of Practice and Procedure, and the Regulations under the Natural Gas Act. (18 CFR, Chapter I), a public hearing be held upon a date to be fixed by notice from the Secretary concerning the lawfulness of the rates, charges, classifications, and services contained in Pacific’s FPC Gas Tariff, Original Volume No. 1, as proposed to be changed by the aforesaid sheets tendered for filing on August 6, 1957.”

First Revised Sheet No. 15 referred to in the second paragraph above related to rates for industrial gas, but Petitioner’s contract does not include any service under that rate. Second Revised Sheet No. 14 is the sheet fixing rates for industrial interruptible gas under Petitioner’s contract. The Commission did not and could not have suspended these rates because of the *proviso* in Section 4(e). It is clear, however, that the statement

by the Commission that the increased rates and charges were not shown to be justified, and that they may be unjust, unreasonable, unduly discriminatory or preferential or otherwise unlawful, applied to Second Revised Sheet No. 14, as well as to the rates which were suspended. It is equally indisputable that the Commission's finding that it was necessary and proper in the public interest, and to aid in the enforcement of the provisions of the Natural Gas Act, that the Commission enter upon a hearing concerning the lawfulness of the rates, charges, classifications and services contained in Pipeline Corporation's Federal Power Commission gas tariff, Original Volume No. 1, as proposed to be changed by the tariff sheets tendered on August 6, 1957, included the rate change provided by Second Revised Sheet No. 14, under which purchaser purchases industrial gas, as well as to the rates for other classes of service. This finding by the Commission, coupled with the fact that at the end of the maximum suspension period the increased rates and charges for other than industrial gas were, by order issued April 28, 1958, permitted to become effective upon condition that Pipeline Corporation file bond to assure refund (R. 1219-27), establishes without question that the threat of taking of Petitioner's property without due process if the industrial rate is not rejected and Petitioner must pay it, effective September 5, 1957, is not illusory or inconsequential. The fact that by order issued September 25, 1959 (R. 1372-4) the Commission allowed Pipeline Corporation to substitute its undertaking for the surety bond in no way detracts from the finding that the rate increase provided by Second Revised Sheet No. 14 was not justified by the showing

made to support it when filed, and that it may be unjust, unreasonable, unduly discriminatory or preferential, or otherwise unlawful.

The conclusion that there is a real and substantial threat of unconstitutional taking if the Commission's order permitting the filing under Section 4(d) is permitted to stand is supported by a more general view of the situation. In the brief filed by the Solicitor General for the Federal Power Commission on writs of certiorari in the Supreme Court of the United States in *United Gas Pipe Line Co. v. Memphis Light, Gas and Water Division*, 358 U.S. 105, 3 L.Ed.(2d) 153, it was stated in Footnote 52a on page 80:

“During the calendar year 1956, the Commission ordered refunded to gas purchasers over \$63 million paid to pipelines which had been based on rates placed into effect subject to refund under Section 4(e), and ultimately found unlawful by the Commission.”

There is no reason to believe that in filing industrial rates which are not subject to suspension, refund or reparation, a natural-gas company will be more restrained than in filing increased rates for classes of service which are subject to suspension and to refund.

In its petition to the Commission for reconsideration (R. 1375-93) Petitioner stated that in the year 1957 it purchased from Pipeline Corporation under the contract of May 3, 1957 a total of 40,830,744 Therms of natural gas for distribution and resale to its customers, of which 40,304,671 Therms, or 98.7% of the total, was purchased

for resale for industrial use only. An increase of .36c per therm on this volume would have amounted to \$123,332.00 for this partial year, had the increased rate provided in the filing of August 6, 1957 been the rate provided in the May 3, 1957 contract.

If the order of the Commission under review stands, the increased rate will be effective from September 5, 1957 continuing to the present and for some unknown and unforeseeable period in the future. Although the Commission's order issued September 4, 1957 (R. 817-9) ordered a hearing concerning the lawfulness of this rate increase, no such hearing has been held, nor has a time for such a hearing been noticed. Two years have elapsed. This delay is understandable. In rate proceedings of the nature to be presented in the ordered hearing, it is to be expected that periods of four to five years may elapse before final determination. It is not to be expected that a natural-gas company will cooperate to expedite such a matter when it concerns industrial rates which during the whole interim period of years must be paid without any obligation or liability on the part of the natural-gas company to make refund if ultimately found unlawful.

Not only will such interim payments be made without any right to refund or to reparations, but Petitioner has also been deprived by the Natural Gas Act of any right to recover such unlawful payments by court action. *Montana-Dakota Utilities Co. v. Northwestern Public Services Co.*, 341 U.S. 246, 95 L.Ed. 912; *T.I.M.E., Inc. v. United States of America*, 3 L.Ed.(2d) 952, de-

cided by the Supreme Court of the United States May 18, 1959. No substitute remedy of any kind has been provided by the Act. Petitioner is left to the arbitrary will of Pipeline Corporation. Such a statutory scheme is a flagrant denial of due process. Constitutional Law, 12 Am. Jur. 279, §582; Constitutional Law, 16A C.J.S. 767, §614; *Chicago, Milwaukee & St. Paul Ry. Co. v. State of Minnesota*, 134 U.S. 418, 33 L.Ed. 970; *Truax v. Corrigan*, 257 U.S. 312, 66 L.Ed. 254; *Gilman v. Tucker*, 128 N.Y. 190, 28 N.E. 1040, 13 L.R.A. 304; *Detroit Trust Co. v. Stormfeltz-Loveley Co.* (Mich.), 242 N.W. 227.

Petitioner is a public utilities company. We perceive no reason why it is not as fully entitled to the protection of the Fifth Amendment as is Pipeline Corporation. Under fundamental principles that protection cannot be denied Petitioner. The rule with respect to due process as applied to public utilities is succinctly stated in 12 Am. Jur. 373, §698, as follows:

§698. Public Utilities. . . . In accordance with the general principles of reasonableness and fair play required of all governmental activity or regulation by the due process clauses of the Fifth and Fourteenth Amendments to the Federal Constitution and similar clauses in the various state Constitutions, although it is settled that the states may regulate the business of public utilities, including not only regulation of public service property, but the compensation to be paid for its use, because such businesses are of a nature in which the public have an interest or use, or, to use a phrase which has become historical in connection with the regulation of utilities and allied enterprises, namely, because they are businesses affected with a public

interest, it is equally well settled that the property of public utilities is private property of which a person cannot be deprived without due process, which entails reasonable compensation in every case for its taking. . . .

“A public utility must be afforded some opportunity to be heard as to the reasonableness of the rates fixed for its charges by a rate-fixing commission. The right to a fair and open hearing is one of the rudiments of fair play assured to every litigant by the Federal Constitution as a minimal requirement. There must be due notice and an opportunity to be heard, the procedure must be consistent with the essentials of a fair trial, and the commission must act upon evidence and not arbitrarily. Such procedure is an inexorable safeguard. Moreover, there can be no compromise on the footing of convenience or expediency or because of a natural desire to be rid of harassing delay when such minimum requirements are ignored. . . .”

These principles are common ground and there is no purpose in referring to the many decisions of the Supreme Court of the United States which are cited to support the foregoing text. It cannot be denied that Petitioner is entitled to these rights, and that the Natural Gas Act deprives it of them. Respondent may say that this incongruity is justified because if Pipeline Corporation's rates are too low it has no means of recouping the loss of its property, while Petitioner can do so by imposing the unlawful rates upon its customers. Such an argument is contrary to fundamental right and justice. Moreover, it is illusory. Petitioner is a regulated utility and can increase its rates only subject to control of the state regulatory body of the State of Washington. More importantly, it overlooks the fact that Petitioner's

customers may not choose to pay rates predicated upon unreasonable and unlawful charges being passed on to them. The complete answer to such a view is found in the opinion of the Court of Appeals of the Third Circuit in the case of *Natural Gas Pipeline Co. v. Federal Power Commission*, 253 F.(2d) 3, at page 9, where it said:

“Finally, respondent and intervenor by motion to dismiss and on the merits maintain that petitioner is not aggrieved by any of the Commission orders involved.

“We have dealt with the order of February 24, 1956 immediately above. Other than it, the argument seems to be that because the advance in the price to Natural has been reflected in the price to its customers, Natural has not been aggrieved.

“This proposition is at the least, unrealistic. Natural is entitled to deal with its customers ethically and, engaged in a fiercely competitive business as it is, must do so in order to survive. It could not stand by and suffer an unlawful fifty-seven per cent increase to be loaded on its purchasers. There is no indication that the latter are captive buyers or that they would submit to that sort of treatment. So it has been not only high level business but sound business for Natural to contest the issue. All in all Natural is truly an aggrieved person within §19(b) of the Act.”

Respondent may urge that the decision of the Supreme Court of the United States in *United Gas Pipe Line Co. v. Memphis Light, Gas and Water Division*, 358 U.S. 105, 3 L.Ed.(2d) 153, should govern. Without reference to more particular differentiations, we believe the short and conclusive answer is that, first, the contract under consideration there contained no provision

giving the purchaser distributor the right to protest increases before the Federal Power Commission, and second, the constitutional question raised in this proceeding before the Federal Power Commission and before this court was not raised in that proceeding, either before the Federal Power Commission or the court.

CONCLUSION

In conclusion, we submit that the Federal Power Commission erred in denying Petitioner's motion to strike the filing under Section 4(d) of the increased rate for industrial gas because Pipeline Corporation bargained away the right to make such a unilateral filing by its contract, and, if this contention be not sustained, then because to permit such a unilateral filing would deprive Petitioner of its property without due process, contrary to the Fifth Amendment to the Constitution of the United States.

Respectfully submitted,

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APPENDIX A

The Natural Gas Act of 1938, 52 Stat. 821, as amended, 15 U. S. C. 717, *et seq.*, provides, in pertinent part, as follows:

SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time, (not less than sixty days from the date this Act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas com-

pany in any such rate, charge, classification, or service, or in any rule, regulations or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published .

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, or State commission, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect: *Provided*, That the Commission shall not have authority to suspend the rate, charge, classification, or service for the sale of natural gas for resale for industrial use only; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made

at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. * * *

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

SEC. 19 (b) Any party to a proceeding under this Act aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the circuit court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be served upon any member of the Commission and thereupon the Commission shall certify and file with the court a transcript of the record upon which the order complained of was entered. Upon the filing of such transcript such court shall have exclusive jurisdiction to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. * * *

No. 16,498

In the

United States Court of Appeals

For the Ninth Circuit

PACIFIC NATURAL GAS CO.,
Petitioner,

vs.

FEDERAL POWER COMMISSION,
Respondent.

PACIFIC NORTHWEST PIPELINE CORPORATION,
Intervener.

Brief for Intervener,
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On Petition to Review an Order of the Federal Power Commission

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No. 16498

In the

United States Court of Appeals

For the Ninth Circuit

PACIFIC NATURAL GAS CO.,
Petitioner,

vs.

FEDERAL POWER COMMISSION,
Respondent.

PACIFIC NORTHWEST PIPELINE CORPORATION,
Intervener.

Brief for Intervener, Pacific Northwest Pipeline Corporation

STATEMENT OF THE CASE

1. Proceedings Below.

Misconceiving the law because of an erroneous decision by the Court of Appeals for the District of Columbia Circuit, eighteen moving parties filed nine motions with the Federal Power Commission to reject revised tariff sheets filed by Pacific Northwest Pipeline Corporation pursuant to section 4(d) of the Natural Gas Act, 15 U.S.C. 717c(d). After the Supreme Court reversed the

Court of Appeals, the Commission denied the motions. R. 1372. Seventeen of the movants have made no further objection to the Commission's order. One of them, Pacific Natural Gas Co., brings the order here for review.

Pacific Northwest is a "natural-gas company", that is, it sells natural gas in interstate commerce for resale. Act § 2(6), 15 U.S.C. 717a(6). Under a certificate issued by the Commission in 1954, Pacific Northwest built a pipeline through which it transmits gas from the San Juan Basin in Colorado and New Mexico, and other fields in Colorado and Wyoming, and sells it in Colorado, Utah, Wyoming, Idaho, Oregon and Washington to local distributing companies (including Pacific Natural), municipalities and others. R. 4, 5; *Northwest Natural Gas Co.*, CCH Util. Law Rep. ¶ 9416, 6 PUR 3d 403.

The Act requires Pacific Northwest to keep on file with the Commission tariff schedules showing all its rates. § 4(c), 15 U.S.C. 717c(c). July 29, 1957, as permitted by its service agreements with its customers, *infra* pp. 4-6, Pacific Northwest established new schedules increasing its rates, and August 6, 1957, as required by § 4(d) of the Act, it filed the new schedules with the Commission. R. 434-687. They were estimated to involve increases of about \$5,500,000 a year, R. 817, of which only a small fraction applied to sales of industrial gas¹ to Pacific Natural, the petitioner here. Pet. Br. 15-16.

The industrial rates became effective September 1, 1957, as specified by Pacific Northwest. Act § 4(e), R. 16, 437. September 4, 1957 the Commission suspended, as § 4(e) empowers it to do, all of the revised rate schedules except those for industrial gas. R. 817, 818. No one, including the petitioner here, objected that this order should also have suspended the industrial rate schedules, or that the Commission should have rejected the industrial rate

1. Like petitioner, we use the term "industrial gas" as shorthand for the phrase in § 4(e), proviso, "natural gas [sold] for resale for industrial use only."

schedules, or refused to permit them to become effective. This order initiated the proceeding, Docket No. G-13202, out of which eventuated the order now brought here for review.

November 21, 1957 the Court of Appeals, District of Columbia Circuit, startled the gas industry by its decision in the "*Memphis*" case. *Memphis Light, Gas & Water Div. v. FPC*, 250 F.2d 402. The Court held that a natural-gas company could not make or file an increased rate without its purchaser's consent to the precise level of the new rate, and in the absence of such agreement the Commission had no jurisdiction to receive or consider the new rate schedules.

Numerous motions were then filed by distributing companies and State Commissions in this and other proceedings² to reject revised rate schedules on which proceedings were pending, to prevent them from becoming effective and to order refunds and dismiss the proceedings. In the present case, such motions were filed by three State Commissions,³ four distributing companies, including the petitioner here,⁴ and ten industrial users of Pacific Northwest-supplied gas.⁵ Each of these motions, including that of the petitioner here, relied exclusively on the *Memphis* case. But the Commission, as § 4(e) requires it to do when the proceed-

2. See, e.g., *El Paso Natural Gas Company*, 19 F.P.C. 154, *affirmed sub nom. Nevada Natural Gas Pipe Line Co. v. FPC*, 267 F.2d 405.

3. *Washington Public Service Commission*, R. 1003; *Public Utility Commissioner of Oregon*, R. 1085; *Public Service Commission of Utah*, R. 1132.

4. *Mountain Fuel Supply Company*, R. 1015, *Public Service Company of Colorado*, R. 1052; *Pacific Natural Gas Co.*, R. 1061; *Washington Natural Gas Company*, R. 1154.

5. *Coos Bay Pulp Corp.*, *Crown Zellerbach Corporation*, *Hooker Electrochemical Company*, *Longview Fibre Company*, *Pacific Northwest Alloys, Inc.*, *Pennsalt Chemicals Corporation*, *Puget Sound Pulp and Timber Co.*, *Scott Paper Company*, *Seattle Steam Corporation*, and *Weyerhaeuser Timber Company*, R. 1273. The Commission also treated certain statements in the petition for leave to intervene of *Kaiser Aluminum & Chemical Corporation*, R. 849, as a motion to reject, and denied it along with the rest. R. 1372-73.

ing has not been completed within the suspension period, permitted the nonindustrial rate schedules to become effective on February 5, 1958, subject to refund. R. 1142.

The Supreme Court granted three writs of certiorari in the *Memphis* case, 355 U.S. 938, and on December 8, 1958, reversed the Court of Appeals, holding that in the case of a service agreement such as Pacific Northwest has with its customers, including the petitioner here, the natural-gas company is fully justified in establishing and filing new rate schedules. *United Gas Pipe Line Co. v. Memphis Light, Gas and Water Div.*, 358 U.S. 103.

The Commission thereafter denied all the motions to reject. R. 1372. Only the present petitioner, Pacific Natural, filed a petition for rehearing, R. 1375, as a prerequisite to court review. Act § 19(a), 15 U.S.C. 717r(a).

2. The Service Agreements.

The record discloses that Pacific Northwest and Pacific Natural have eight effective service agreements, only one of which covers industrial gas.⁶ In addition, Pacific Northwest has eight municipality and thirteen distributing company customers, R. 45-47, with whom it has more than seventy presently effective service agreements covering distribution system, industrial and other forms of service. R. 49-433.

Every one of these several-score agreements, whether for industrial gas or other gas, and including those with petitioner, contains precisely the same provisions with respect to the making and filing by Pacific Northwest of rate schedule changes. Commission

6. R. 309, 313, 317, 321, 325, 329, 333, 344. The industrial service agreement attached to Pacific Natural's Motion to Reject, R. 1061, 1067, and referred to in its brief here, Pet. Br. 5, was not, as noted by the Commission in its Order Denying Reconsideration, R. 1409, 1410n, an effective filed service agreement at the time the proceedings were before the Commission. However, as the Commission also noted, its provisions in regard to rate schedule changes are the same as those of the effective agreement, R. 344, 345.

regulations require that the form of service agreement be filed with the tariff, 18 C.F.R. 154.34, and Pacific Northwest's service agreement forms have never been altered since the tariff was originally filed in 1956. R. 36, 39. There were only two of them,⁷ and each contains the following paragraph, R. 37, 39:

"Buyer agrees to pay Seller for all natural gas service rendered under the terms of this Agreement in accordance with Seller's Rate Schedule as filed with the Federal Power Commission, and as such rate schedule may be amended or superseded from time to time. This Agreement shall be subject to the provisions of such rate schedule and the General Terms and Conditions applicable thereto on file with the Federal Power Commission and effective from time to time, which by this reference are incorporated herein and made a part hereof."⁸

The General Terms and Conditions referred to in the Service Agreements contain, and have always contained, the following paragraph, R. 34:

"Seller's rates, charges, classifications and services as set forth in this Tariff are subject to regulation by the Federal Power Commission under the Natural Gas Act. Seller shall have the right to file from time to time with the Federal Power Commission under Section 4 of the Natural Gas Act such new rate schedules and changes in its existing effective Tariff as Seller may find necessary from time to time to assure Seller just and reasonable rates and charges as well as a rate of return sufficient to service the Seller's debt, attract capital, insure expansion and provide adequate natural gas service to all Seller's customers. Without in any way limiting the generality of the foregoing, Seller shall have the right to file new rate schedules fairly and appropriately reflecting changes in the rates and charges paid by Seller for natural

7. A third form containing the same provisions was added in 1957. R. 42.

8. That each of the agreements between Pacific Northwest and petitioner Pacific Natural contains this provision may be seen by consulting the agreements themselves, at R. 311, 315, 319, 323, 327, 331, 335, 345.

gas. Buyer shall have the right to protest any such new rate schedules and changes before the Federal Power Commission."

On the basis of these contractual provisions, the Commission held (and all of Pacific Northwest's customers except the present petitioner apparently agree) that "Pacific Northwest's reservation of the right to change rates and to file such changes with the Commission was complete and unequivocal." R. 1411.

SUMMARY OF THE ARGUMENT

1. a. In the *Mobile* case, 350 U.S. 332, it was held that a seller of gas cannot file increased rates where it has contracted not to do so. In *Memphis*, 358 U.S. 103, the Supreme Court made it clear that this rule applies only to a fixed rate contract, and does not affect the usual tariff-and-service agreement arrangements, which leave the seller free to fix and file new rates.

b. The Pacific Northwest service agreements are not fixed rate contracts, hence the rule of the *Mobile* case does not apply. The language of the Pacific Northwest agreements was drawn in the light of the *Mobile* case, and is indistinguishable from that involved in the *Memphis* case. Like the agreements in *Memphis*, it appears in a form attached to a tariff as required by the Commission's regulations, and clearly reserves to Pacific Northwest the right to change its rates.

c. Petitioner refers to a sentence in the General Terms and Conditions on file with the Commission, which reaffirms in the buyer "the right to protest any such new rate schedules and changes before the Federal Power Commission," claiming that it is inconsistent with the seller's right to change its rates. *If* the regulation were inconsistent with the agreement, it would be inapplicable and inoperative. But when reasonably interpreted, it is not inconsistent. All that it means is that buyer does not waive its rights under the statute to participate in the proceedings involving the justness and reasonableness of the new rates. A contract to pay

whatever price the seller may fix for its purchasers generally is valid. Even if the price clause of the service agreement were invalid, the seller's right to file rate changes would stand. Petitioner's present position on the "right to protest" clause is an afterthought. Prior to the motion to reject, it construed the clause to mean exactly what it says. El Paso Natural Gas Company's service agreements containing such a provision were approved by the Court of Appeals as *Memphis*-type service agreements.

2. The Commission found that these were not intended to be fixed-rate contracts. That finding is supported by the language of the agreements, by the meaning accepted by all of Pacific Northwest's other purchasers, and by the general understanding of the industry. Only the present petitioner maintains a contrary position; and even petitioner itself did not make any such claim until after the decision by the Court of Appeals in *Memphis* on November 21, 1957. As the Supreme Court held in *Memphis*, decision of this question is a matter "peculiarly within the area of the Commission's special competence." 358 U.S. 112. There is no contrary evidence in the record, and the finding of the Commission is conclusive. Act § 19(b), 15 U.S.C. 717r(b).

3. The petitioner's constitutional arguments are without merit.

a. Petitioner's constitutional claim is limited to the proposition that Congressional failure to empower the Commission to suspend industrial rates and order refunds with respect to them "permits the taking of petitioner's property without due process of law," because in the interim between rate filing and final order, it may pay more for gas than the rate the Commission may ultimately fix. This obligation, however, is rooted in the contract, not the Act; the Act does not affect the contractual freedom of buyer and Seller to fix rates by contract; Congress merely refrained from changing the existing contractual situation. Refusal to regulate is not a denial of due process.

Petitioner assumes that any rate except the one ultimately fixed by the Commission is unjust and unreasonable, and therefore

unlawful. But rates may be just and reasonable even though the Commission later decides to decrease them, for the Commission may reduce *a* reasonable rate to what in its judgment is "*the lowest reasonable rate.*" But the filed rate, unless and until decreased, is not merely a lawful rate, but the only lawful rate.

Petitioner assumes that before the Act, a purchaser had a right to reparations for unreasonable rates, and that its remedy was abolished by the Act. But no such right or remedy in fact existed. Even had the Act abolished a preexisting right, it deprived petitioner of nothing since petitioner's agreements were made long after the Act was adopted. There is no vested right in any particular rule of law, and for Congress to change the law prospectively does not deny due process.

Nothing done by Congress, or by the Commission, takes anything from petitioner, and the Fifth Amendment restrains only action by the Federal Government. A natural gas company can raise any rate, industrial or otherwise, without customer consent, because that is a normal right of all public utilities (when there is no contractual barrier), and the service agreements in this case specifically reserve and confirm that right to the seller. No "taking" is involved in holding petitioner to its agreement. Petitioner's argument that it, being a regulated utility, is entitled to due process protection, is irrelevant since it is exempt from the Natural Gas Act and not subject to any federal regulation.

In summary, the reason that the seller may increase its rates is that petitioner agreed that it might. The failure, if any there was, to afford petitioner the "protection" it now claims was not a failure of Congress in writing the Natural Gas Act, but a failure of petitioner to contract for its gas supply on a fixed rate basis.

b. The Natural Gas Act has withstood repeated constitutional attack since its passage in 1938. The Supreme Court and the Courts of Appeals have each time held it valid. The Supreme Court in the *Memphis* case (wherein no claim of unconstitutionality was made) considered the provisions respecting nonsuspendible indus-

trial rates as valid, particularly where, as here, the distributing company (petitioner) has a contractual right to pass on pipeline rate increases to its own customers.

c. Constitutional arguments have no place in the case. The record shows that the petitioner will not itself be required to bear the cost of any price increases established by Pacific Northwest, but will recoup from its own customers all of such increases. In every instance but one escalator clauses so provide, and in the remaining case it can be done with the consent of the Washington Public Service Commission. One who is not himself harmed by the operation of a statute will not be heard to claim that it is unconstitutional. The constitutional arguments are irrelevant to the disposition of the case, for even if they were upheld, the result would not be affected. If the *contractual* provisions for rate schedule changes were invalid, the result would be a binding contract for the purchase and sale of gas with no price term, and Pacific Northwest would have its right to make rate changes, which it must then file under § 4(d), subject to Commission review under § 4(e). Even if the *statutory* provisions were held invalid, no greater right to protest would be afforded to petitioner, no power would exist to suspend an industrial rate or to order reparations, since no statutory authority exists to do either. Therefore, the relief requested by petitioner could in no event be granted.

ARGUMENT

1. The Service Agreements Are Typical "Memphis" Type Agreements, Plainly Reserving and Confirming to Pacific Northwest the Right to Make and File Rate Schedule Changes.

a. The Mobile and Memphis Cases.

In the *Mobile* case, the Supreme Court held that the Natural Gas Act did not abrogate rate contracts, but only made them subject to the requirement of filing, and to the jurisdiction of the Commission to change them under § 5(a). Section 4(d) did not grant to the seller the power to change his contract, but merely

prohibited him from doing so without notice to the Commission. Therefore, if a buyer and seller had contracted for gas service at a fixed rate for a term, nothing in the Act empowered the seller to change the rate. *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332, 338-40, 342-43.

The Court of Appeals in the *Memphis* case "misconceived the import of [the] decision in *Mobile*." 358 U.S. at 109. It held that under *Mobile*, the seller could never change the rate, whether set forth in a special contract or a general tariff, unless the buyer agreed to the precise level of the new rate, and that a contractual consent by the buyer to the seller's filing of new rates was not enough. The true rule, as the Supreme Court held in the *Memphis* case, is that the seller may change the rate and file it under § 4(d) unless he has agreed by contract not to do so. 358 U.S. 103, 111, 112-13. What is needed, therefore, to avoid the *Mobile* result is not an agreement to a specific new rate, but merely the absence of any agreement that no new rate will be filed.

The result of the *Mobile* and *Memphis* cases is this:

(1) Where a natural gas company agrees with its buyer that it will furnish service at a fixed rate for the entire term of the contract, the agreement is valid and binding unless the Commission finds in a § 5(a) proceeding that the rate is unreasonable; and the seller cannot file changed rates applicable to that buyer under § 4(d).

(2) Where, however, the natural gas company agrees to furnish service at the filed rate, this agreement is also valid and binding, and the seller retains the right to change its rates by establishing new schedules and filing them under § 4(d), subject to the Commission's option to review them, with or without suspension, under § 4(e).

b. Interpretation of the Present Agreements in the Light of *Memphis* and *Mobile*.

The agreements here involved contain a provision reserving and confirming to Pacific Northwest its right to make and file rate

schedule changes, and another is incorporated by reference. The latter, paragraph 10 of the General Terms and Conditions of Pacific Northwest's Tariff, appears at R. 34, is quoted twice by petitioner in its brief, Pet. Br. 6, 8-9, and is also quoted *supra* pp. 5-6.

The provision in the service agreement itself is quoted at Pet. Br. 6,⁹ and *supra* p. 5. It will prove helpful not only to quote it once again, but to do so opposite the comparable provision of United Gas Pipe Line Co.'s service agreement which was involved in the *Memphis* case:

PACIFIC NORTHWEST¹⁰

Buyer agrees to pay Seller for all natural gas service rendered under the terms of this Agreement in accordance with Seller's Rate Schedule as filed with the Federal Power Commission, and as such rate schedule may be amended or superseded from time to time.

This agreement shall be subject to the provisions of such rate schedule and the General Terms and Conditions applicable thereto on file with the Federal Power Commission and effective from time to time, which by this reference are incorporated herein and made a part hereof.

UNITED GAS¹¹

All gas delivered hereunder shall be paid for by Buyer under Seller's Rate Schedule (the appropriate rate schedule designation is inserted here), or any effective superseding rate schedules on file with the Federal Power Commission.

This agreement in all respects shall be subject to the applicable provisions of such rate schedules and to the General Terms and Conditions attached thereto and filed with the Federal Power Commission which are by reference made a part hereof.

9. Petitioner refers only to the agreement for industrial gas. The identical provision is found in all of the service agreements—eight with petitioner, and seventy-odd with other customers, *supra* p. 5.

10. Appears in service agreement forms at R. 37 and 39 with the rate schedule designation left blank, and in each of the service agreements in the record with the rate schedule designation inserted. For Pacific Natural service agreements, see R. 311, 315, 319, 323, 327, 331, 335 and 345.

11. *Memphis*, 358 U.S. at 105.

The *Memphis* agreement was held to reserve the seller's right to make rate changes, and file them under § 4. There is not the slightest difference of substance between the *Memphis* service agreement, and that involved here.¹² Even without the authority of *Memphis*, the service agreements so clearly reserve the seller's right that no other result could reasonably follow. As the Supreme Court recently remarked in the *CATCO* case, the seller "may, unless otherwise bound by contract [citing *Mobile*], file new rate schedules with the Commission." *Atlantic Refining Co. v. PSC*, 360 U.S. 378, 389. In other words, under *Mobile* itself, even without the additional light shed by *Memphis*, the question is not whether seller has exacted from buyer a permission to exercise its rights under § 4; the question is only whether seller has promised that it will *not* exercise those rights, which are its normal rights in the absence of contrary agreement. *Mobile*, 350 U.S. at 343.

What we are to look for, then, in determining the nature of these service agreements, is not necessarily a provision *granting* to the seller the right to make and file rate schedule changes; that right exists as a matter of law *unless* it has been bargained away. *CATCO*, *supra*, 360 U.S. at 389; *Memphis*, 358 U.S. at 112-13. What we must look for in order to bring the case within *Mobile* is a commitment that the initial rate shall be the fixed and only rate for the entire term of the agreement.¹³ Unless we find that, the arrangement is governed by *Memphis*, not *Mobile*.

These agreements have no such provision. Indeed, they contain no rates at all, initial or otherwise, but refer exclusively to the

12. Pacific Northwest's agreement is stronger than that in *Memphis*, for there the agreement was only to pay in accordance with "any *effective* superseding rate schedules"; and it was strenuously argued that the word "effective" was meant to limit buyer's duty to pay to new schedules established after a § 5(a) proceeding. The Supreme Court's answer to this argument, 358 U.S. at 116, note 10, is discussed in some detail *infra*, pp. 35-36.

13. The *Mobile* contract was "a 10-year contract to supply gas for resale . . . at the equivalent of 10.7 cents per Mcf. . . ."

filed tariff for a statement of the rates. They go farther, and in clear language reserve to the seller, Pacific Northwest, the right to make and file rate schedule changes. The *Mobile* case had been decided by the Commission in December, 1953, 12 F.P.C. 1422, before Pacific Northwest entered into its first service agreement; it was reversed by the Court of Appeals, 215 F.2d 883, which in turn was affirmed by the Supreme Court on February 27, 1956, before Pacific Northwest's General Terms and Conditions were filed. It seems obvious that the agreements and the conditions were drafted with a careful eye to overcoming the *Mobile* result, by requiring the agreement of the buyer to pay in accordance with the designated schedule "as such rate schedule may be amended or superseded from time to time," and even more clearly by the provision in the General Terms and Conditions that

"Seller shall have the right to file from time to time with the Federal Power Commission under Section 4 of the Natural Gas Act . . . new rate schedules and changes in its existing effective Tariff . . ."¹⁴

In the face of these provisions, it would be idle to argue that a fixed rate contract was intended. And under the *Mobile* case, that is the end of the matter.

c. The "Right to Protest" Clause Does Not Detract from the Plain Meaning of the Price Clause.

Petitioner does not argue that a fixed-rate contract was intended—and thereby concedes the case. All it argues is that the last sentence of paragraph 10 of the General Terms and Conditions, R. 34, detracts from the right plainly given by the service agreements. This sentence reads, R. 34, "Buyer shall have the right to protest any such new rate schedules and changes before the Federal Power Commission." Petitioner contends that this

14. Petitioner concedes that the language which might be thought to qualify this right "creates wholly a subjective standard", and that but for the last sentence, the effect "would not be different legally than if the right had been unqualified." Pet. Br. 9.

sentence deprives Pacific Northwest of the right to file new industrial rate schedules. Pet. Br. 10-11.

This language cannot reasonably bear the meaning petitioner contends for; it means exactly what it says, nothing more: that buyer, like seller, is to have the usual right to appear before the Commission, and be heard with respect to the reasonableness and justness of the new rates. Since the paragraph has just stated that seller has not waived its rights under § 4 of the Gas Act, it is entirely reasonable to go on and say that buyer, too, shall not be estopped to appear, protest, and exercise its other rights under the Act, whatever they may be.

The right-to-protest clause is not written out in the service agreement; it is part of the general terms and conditions upon which Pacific Northwest offers service to its customers, and which Pacific Northwest has filed with the Commission as the law and the regulations require. 18 C.F.R. § 154.39. The service agreement, on the other hand, *is* a contract, and incorporates by reference the **applicable** provisions of the General Terms and Conditions.

The service agreement itself provides in the clearest terms that the seller does not relinquish its right to make and file new rate schedules, including industrial, by the clause binding the buyer to pay "as such rate schedule may be amended or superseded from time to time." If the "right to protest" clause—not written in the agreement itself but merely incorporated by reference as a part of eight pages of General Terms and Conditions—meant what petitioner says it means, it would be in flat conflict with the words of the agreement itself, and with its clear meaning and intent. In such a case, the rule of interpretation would apply, that where a document of general applicability is incorporated by reference into a contract, and there is conflict, the terms of the contract rather than those of the incorporated document control. *Daly v. Busk Tunnel Ry. Co.*, 129 Fed. 513; *Hill & Combs v. First Nat. Bank*, 139 F.2d 740; *Perry v. United States*, 146 F.2d 398.

But resort to that rule of construction need not be had in this case, for the service agreement itself provides that the General Terms and Conditions are incorporated into the service agreement only to the extent that they are "applicable thereto". R. 39. Clearly, if the "right to protest" clause in the General Terms and Conditions means what petitioner claims, it could not be "applicable" because it would deprive the gas company of a right explicitly granted by the service agreement itself, the right to amend and supersede its rate schedules from time to time.¹⁵

It is suggested, Pet. Br. 11, that unless the agreement is construed as petitioner would have it, it is invalid under general law. That, of course, is a matter which does not concern this Court; for all that is here for review is an order denying a motion to reject rate schedules in toto, and the question before this Court relates not to the enforceability of a private contract but to the jurisdiction of the Federal Power Commission to accept rate schedules for filing, and to proceed to exercise its concededly valid statutory functions with respect to them.

Even here, both petitioner's premise and its conclusion are wrong. These service agreements are, it is true, private sales contracts, but they are something more. They refer for prices to a tariff, filed as required by law, wherein the seller sets out the price to be paid not by a single buyer, but by all buyers

15. Another relevant rule of construction is that contracts must be read in the light of the law existing when the contract is made. *Wood v. Lovett*, 313 U.S. 362, 370; *State of Washington v. Maricopa County*, 152 F.2d 556, 559, cert. denied 327 U.S. 799. The Natural Gas Act at the time these service agreements were made forbade the Commission to suspend an industrial rate. Before the first of the agreements here in question was made, it had been held that an industrial rate was not subject to refund. *Mobile Gas Service Corp.*, 12 F.P.C. 1422, 1424. All parties to the service agreements knew these things. Yet they agreed that seller should have the right to file new rates, and buyer should have the "right to protest", without making any distinction as to either right between industrial and other rates. Read in this light, the clause means simply this: that buyer shall have the right to protest all new rate schedules, industrial and other, *in accordance with existing law*, which does *not* provide for suspension of industrial rate schedules.

of the same kind of service. A contract binding a buyer to pay whatever rate seller may post, or list, or offer to purchasers generally, is valid.¹⁶

Petitioner concludes that application of the rule it contends for "would invalidate the provisions of the contract relating to change of price for industrial gas and leave the named rate fixed in the contract in effect . . ." Pet. Br. 11. But there is not, and never was, any "named rate fixed in the contract"; the only agreement there is, or ever was, as to price, is that buyer will pay seller for gas in accordance with seller's rate schedule on file with the Commission, "as such rate schedule may be amended or superseded from time to time." R. 39. The contract could not be "interpreted" to require seller to deliver gas at a rate that had been superseded; that would turn the service agreement into a fixed-rate contract, which nobody intended.

Petitioner's stated reason for its contention as to the meaning of the clause is, that although it as buyer has a right under the law to protest *all* rate schedules before the Commission, including industrial, its right to protest industrial rate schedules is less "real and substantial", Pet. Br. 10, than its right to protest

16. *Cities Service Gas Producing Co. v. FPC*, 233 F.2d 726, cert. denied 352 U.S. 911 (prevailing field price for gas); *Col-Tex Refining Co. v. Coffield & Guthrie, Inc.*, 196 F.2d 788 (posted price for crude oil); *Shamrock Oil & Gas Corp. v. Coffee*, 140 F.2d 409 (market price for gas); *Buggs v. Ford Motor Co.*, 113 F.2d 618, cert. denied 311 U.S. 688 (list price for auto accessories and parts, subject to change by seller); *Ken-Rad Corporation v. R. C. Bohannon, Inc.*, 80 F.2d 251 (list price for radio tubes, subject to change by seller); *a fortiori*, when the prices are subject to governmental review, *Pfotzer v. United States*, 176 F.2d 675 (agreement to pay price allowed by OPA); *RFC v. United Distillers Product Corp.*, 113 F. Supp. 468, affirmed 204 F.2d 511 (same); *Outlet Embroidery Co. v. Derwent Mills*, 254 N.Y. 179, 172 N.E. 462 (prices subject to tariff revision). Moreover, petitioner's argument proves too much, for it would necessarily follow from its interpretation of the "right to protest" clause that the filing of nonindustrial rates would similarly be invalid unless the Commission *did* suspend them, subject to refund, so as to give the petitioner the *kind* of "right to protest" it claims it needs. Cf. *infra*, pp. 26-27. But not even petitioner claims that its agreement should be held to mean *that*.

nonindustrial rates; therefore, says petitioner, since the parties must have intended petitioner to have a "real and substantial" right to protest, seller must be deprived by "interpretation" of the right, plainly granted in the service agreement itself, to file new rates for industrial gas.

Petitioner confuses its contractual *rights* with the Commission's statutory *powers*.

Petitioner has the same *right* to protest industrial rates as it does all other rates; the right to remonstrate when new schedules are filed (as petitioner did here); to petition for leave to intervene (as petitioner did here); to participate in the hearing, if its petition is granted (as petitioner's was here), and the like. There is no distinction at all between industrial gas and other gas with respect to the existence of these *rights* to protest. There is only a distinction with respect to the Commission's statutory *powers*: a request by petitioner, in the exercise of its *right* to protest, that the Commission suspend an industrial rate, would necessarily fall on deaf ears since the power of the Commission to grant such a request does not exist. The parties could not grant petitioner a "real and substantial" right to protest to the Commission against *that*; any protest in that regard would have to be addressed to Congress.

But because the parties to the contract did not have, and knew that they did not have, any power to change the law or to dictate to the Commission how it should administer the law, petitioner's "right to protest" in all other respects is subject to the same infirmity, namely, that its protest may not result in the administrative action the petitioner desires. Petitioner assumes, without justification, that the contract conferred a right that the parties to the contract had no power to confer. Petitioner's protest will not be "real and substantial", in the sense in which petitioner uses those words, if the Commission waives thirty days' notice; or elects not to order a hearing; or orders a hearing without suspension. In any of these cases, the "*right* to protest" would

still exist, but it would turn out to be unavailing, just as a protest would if it demanded the suspension of an industrial rate schedule. But in these cases too, the contracting parties did not have, and knew when they made their contract that they did not have, any power to control the action of the Commission.

Petitioner's argument amounts to a demand that the Court give it what the contract did not and could not give. If petitioner's argument were correct, the words,

Buyer shall have the right to protest any such new rate schedules and changes before the Federal Power Commission,

would have to be interpreted to mean,

Seller shall not have the right to file new rate schedules for industrial gas.

Surely this is too much "interpretation" for a plain English sentence to bear.

Pacific Northwest cannot compel either the Commission to commence a § 5(a) proceeding, or its distributor-customers to agree to new rates, and although petitioner does *not* contend that the service agreement contemplates a fixed rate, petitioner's "interpretation" of the agreement would deprive Pacific Northwest of the *only* method available to it under the law and the agreement of initiating rate changes. Petitioner's argument would destroy one of Pacific Northwest's most valuable rights under the contract. But permitting Pacific Northwest to make and file rate changes, as the agreement provides it may, does not take away or in any manner affect petitioner's "right to protest". As stated by the Commission, R. 1411,

"The right of protest reserved to the Buyer (Pacific Natural) is in no way impaired by acceptance of rate changes filed by the Seller (Pacific Northwest) and the terms of the agreement between the parties [are] carried out . . . Except for the lack of power of suspension by the Commission, the

increased rates for sales for industrial use only are governed by the same requirements, and the right of Pacific Northwest to file such increased rates is as clear as in the case of rates for other sales for resale.”

Petitioner’s present position as to the meaning of the “right to protest” clause is in sharp contrast to its conduct at all times until November 21, 1957 (when the erroneous *Memphis* decision was issued).¹⁷ It is evident that the meaning petitioner now, *post litem motam*, ascribes to the “right to protest” clause is a meaning the clause was never intended to bear, and cannot reasonably be interpreted to bear. It is similar to the meaning the respondents

17. Pacific Northwest’s rate schedule changes, including those for industrial gas, were dated July 29, 1957 and filed August 6, 1957. R. 434, 436. August 7, the Commission invited comments from Pacific Northwest’s customers, including petitioner. R. 690. August 19, 1957, petitioner exercised its “right to protest any such new rate schedules and changes before the Federal Power Commission”, R. 34, by writing a letter to the Commission entitled “Objections in protest of Pacific Natural Gas Co. to rate increase filing of Pacific Northwest Pipeline Corporation.” R. 751. It alleged that it had a number of contracts with industrial gas consumers, and that the rate increase was premature, and the rates were too high, but never did it allege that, either under the service agreement or under the law, Pacific Northwest was without right to file and make effective increases for industrial and other gas. It did not ask that the rate filing be rejected, and did not ask the Commission to prevent the industrial rates from becoming effective.

The very next day, August 20, 1957, petitioner entered into four new service agreements, each of them containing the identical rate-changing provisions that appeared in the prior agreements, without even alleging that Pacific Northwest had no right to file new rate schedules. R. 314, 322, 329, 334. Surely, if petitioner really believed that Pacific Northwest’s filing of August 6, 1957 was a violation of the service agreement, it would not have entered anew into identically worded service agreements, without comment.

The industrial rates became effective September 1, 1957. R. 16. Still petitioner made no claim to the Commission that they were improperly filed, or improperly made effective, or should be rejected. Instead, it again exercised its “right to protest” by filing on September 10, 1957 a petition for leave to intervene, R. 822, again without alleging any contractual or legal barrier to Pacific Northwest’s rate increase filing. It alleged only that “on August 6, 1957 Pacific Northwest filed notice of a change in its rates. This proposed increase will have a direct and significant effect on the consumers served by Pacific Natural.” R. 823.

in the *Memphis* case sought to put upon the "effective superseding rate schedules" clause, and which the Supreme Court rejected. *Infra*, p. 20. Petitioner makes much of the fact that the *Memphis* service agreement contained no "right to protest" clause.¹⁸ There is no indication that, had there been such a clause, it would have affected the result. And in fact, the service agreements of El Paso Natural Gas Company *did* contain such a "right to protest" clause, which read: ". . . provided, however, Buyer shall have the right to protest any such changes in rates and new rates or rate schedules before said Commission, and to exercise any other rights it may have with respect thereto under the Natural Gas Act. . . ." *El Paso Natural Gas Company*, 19 F.P.C. 154, at 156, note 5, affirmed sub nom. *Nevada Natural Gas Pipe Line Co. v. FPC*, 267 F.2d 405. The Commission, before the Supreme Court's decision in *Memphis*, held that El Paso nevertheless did reserve the right to file changes in all its rates, and the Court of Appeals held, 267 F.2d at 409,

"The agreements before us, like those in the *Memphis* case, are typical . . . 'tariff-and-service arrangements'. . . . The 1955 agreements between El Paso Gas and its customers clearly disclose an intention that rates might be changed in accordance with Section 4(d) and 4(e) procedures. Under the rule in the *Memphis* opinion such provisions are valid and do not violate either the letter or the spirit of the Natural Gas Act."¹⁹

18. Whether such a provision was contained in the General Terms and Conditions, as it is here, does not appear in any of the reported opinions in the *Memphis* case. If it was, no one paid any attention to it.

19. There were two sets of service agreements before the Court in that case, entered into in 1955 and 1957 respectively. The 1955 agreements did not, but the 1957 agreements did, contain the "right to protest" clause. The Court of Appeals was "of the opinion that the result would be the same under" either of the agreements. 267 F.2d at 408.

It will be noted that the 1957 clause quoted by the Commission at 19 F.P.C. 156, note 5, is not exactly the same as the one quoted by the Court at 267 F.2d 407. There is, however, no difference of substance in the meaning of the two "right to protest" clauses, and in fact the one quoted by the Commission is the correct one. See Joint Appendix, *Nevada Natural Gas Pipeline Co. v. FPC*, 5th Cir., Nos. 17074 etc., pp. 88, 116.

2. The Commission's Finding as to the Nature of the Service Agreements Is Supported by Substantial and Uncontradicted Evidence, and Relates to a Subject "Peculiarly Within the Area of the Commission's Special Competence".

When the petitioner in its motion to reject for the first time asserted the lack of right in Pacific Northwest to establish and file rate schedule changes, it made no assertion whatever as to the meaning of the service agreements or the intention of the parties; instead, it relied solely on the proposition that, as a matter of law under the Court of Appeals' *Memphis* decision, the Commission had no authority to do other than reject the new rates, and prohibit them from becoming effective. R. 1064-65.

The Commission, in passing upon this motion after the Supreme Court had righted the situation by its *Memphis* opinion, 358 U.S. 103, had before it not only the Supreme Court's two decisions in the *Mobile* and *Memphis* cases, but also a great body of evidence of which it could take official notice, to aid it in deciding whether the agreements of Pacific Northwest are of the one sort or the other.

First, of course, are the service agreements themselves, and their language. But in addition, the Commission had before it its intimate knowledge of the natural gas industry, and the understanding of the industry as to the meaning of such agreements. It knew, and was entitled to consider, the fact that all of Pacific Northwest's gas is sold under service agreements at filed rates, and that there are no special contracts, fixed-rate or otherwise, in this record. Petitioner had never claimed any infirmity in the Act, the Commission's jurisdiction, or the service agreements, or any lack of right in Pacific Northwest to file rate schedule changes and make them effective. In an informal protest and a formal petition for leave to intervene, no claim of contract violation had been made. The Commission was entitled to take into consideration that the vast majority of customers affected were making no such claim, and that petitioner's purchases of industrial gas will

bear only a small part of the total rate increase. Upon all of this evidence, the Commission concluded that these were *Memphis*, not *Mobile*, agreements.

Primarily, of course, the Commission based its decision on the language of the agreements themselves. R. 1372, 1410-11. The decision is one "peculiarly within the area of the Commission's special competence", as the Supreme Court held in the *Memphis* case. 358 U.S. at 114.

"The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive." Act § 19(b), 15 U.S.C. 717r(b). Here, the finding of the Commission as to the intention of the parties is not only substantially supported, but there is no contradictory evidence. We respectfully submit that the Commission's finding should be accepted by this Court, as it was by the Supreme Court in *Memphis*.

3. Petitioner's Constitutional Arguments Are Without Merit.

a. Analysis of Petitioner's Constitutional Objection.²⁰

The only constitutional argument presented in petitioner's opening brief is that "to permit the unilateral filing of rates for industrial gas . . . under section 4(d) of the Natural Gas Act will permit the taking of petitioner's property without due process of law . . .," Pet. Br. 12, because it might permit Pacific Northwest to exact from petitioner an "unlawful" rate, without the possibility of refund or reparation.

The constitutional objection, stated at Pet. Br. 4-5, lies in two areas: (1) in the failure of Congress to grant to the Commission the power of suspension and refund with respect to industrial

20. At various places in the discussion of the constitutional question, we cite some cases dealing with validity of state statutes under the XIV Amendment, rather than of federal acts under the Fifth. The cases are equally applicable, since "the restraint imposed upon legislation by the due process clauses of the two amendments is the same." *Heiner v. Donnan*, 285 U.S. 312, 327; *cf.* *FPC v. Natural Gas Pipeline Co.*, quoted *infra*, p. 35.

rates; and (2) in the failure of Congress to grant petitioner a right to restitution *if* the Commission later holds that the industrial rates which were established by Pacific Northwest were too high.

Note what petitioner does *not* claim. It does *not* claim that the Commission does not have, or constitutionally could not have, power to review the industrial rate changes under § 4(e) and determine their reasonableness, just as it does with respect to nonindustrial rates. It does *not* claim that there is as yet any finding, or even any evidence, that the rates are unjust or unreasonable; and of course that is a matter which is within the exclusive primary jurisdiction of the Commission. *Interstate Nat. Gas Co. v. Southern California Gas Co.*, 209 F.2d 380, 384. Petitioner has no constitutional objection to what may happen to the rates, including industrial rates, *after* the Commission has held its hearing and entered its order. Its objection goes *only* to the interim period between the filing of the changes and the entry of the order—the period during which the other rates may have been suspended, and the industrial rates have not.

Petitioner assumes that during this temporary period, petitioner's "property" is being "taken" under governmental compulsion, because, says petitioner, § 4(d) of the Act "permits" the unilateral filing of rates. Actually, however, § 4(d) "permits" the filing of no rates at all; it merely *prohibits* the establishment of *any* changed rates, whether by agreement or by action of the seller, without filing.

Before the passage of the Gas Act, under an agreement such as the ones here involved, the seller would have the right to change the rates offered to all purchasers, and the contract would be perfectly valid. *Supra*, pp. 15-16. No "taking"—indeed, no governmental action at all—would be involved. The legal duty of a buyer to pay increased rates would stem not from statute, but from contract.

These facts have *not* been changed by the Natural Gas Act. The right of a seller of gas to alter its rates is not "under section 4(d) of the Natural Gas Act" but under its contract. The Act has not altered the status of contracts one whit. The Supreme Court made this clear in the *Mobile* case:

"In construing the Act, we should bear in mind that it evinces no purpose to abrogate private rate contracts as such. To the contrary, by requiring contracts to be filed with the Commission, the Act expressly recognizes that rates to particular customers may be set by individual contracts."²¹

". . . The Natural Gas Act permits the relations between the parties to be established initially by contract, the protection of the public interest being afforded by supervision of the individual contracts, which to that end must be filed with the Commission and made public."²²

"On its face, . . . § 4(d) is simply a prohibition, not a grant of power. It does not purport to say what is effective to change a contract. . . . The section says only that a change *cannot* be made without the proper notice to the Commission. . . ."²³

"The Act merely defines the review powers of the Commission and imposes such duties on natural gas companies as are necessary to effectuate those powers; it purports neither to grant nor to define the initial rate-setting powers of natural gas companies."²⁴

"In short, the Act provides no 'procedure' either for making or changing rates; it provides only for *notice* to the Commission of the rates established by natural gas companies and for *review* by the Commission of those rates. The initial rate-making and rate-changing powers of natural gas companies remain undefined and unaffected by the Act."²⁵

21. 350 U.S. at 338.

22. *Id.* at 339.

23. *Ibid.*

24. *Id.* at 341.

25. *Id.* at 343.

“... The Act presumes a capacity in natural gas companies to make rates and contracts and to change them from time to time. . . .”²⁶

Thus, the duty of petitioner to pay the rates established by Pacific Northwest from time to time is “unaffected” by the Natural Gas Act, is neither granted nor defined thereby, and the only relation that it bears to the Act of Congress is that Congress declined to abrogate it. No authority is known to or found by us, and none is cited by petitioner, which holds or even intimates that the failure or refusal of Congress to regulate voluntary private transactions, or a Congressional decision to regulate such transactions in part only, constitutes a denial of due process; the Supreme Court has answered such arguments by saying that “. . . if we accepted the proposition urged, we would be obliged to announce the contradiction in terms that because Congress has exerted a regulation lesser in power than it was authorized to exert, therefore its action was void for excess of power.” *United States v. Hill*, 248 U.S. 420, 426, quoting *Clark Distilling Co. v. Western Md. Ry. Co.*, 242 U.S. 311, 331; cf. *Roschen v. Ward*, 279 U.S. 337, 339 (“A statute is not invalid under the Constitution because it might have gone farther than it did. . . .”)

Next, petitioner assumes that if the Commission upon review of rate changes filed by a natural gas company fixes rates lower than those filed, it somehow becomes established that the rates originally filed were unjust, unreasonable, and unlawful.²⁷ This assumption is doubly inaccurate.

It is true, of course, that *after* the Commission has fixed reasonable rates and ordered them filed, it would be a violation of the Act—“unlawful”—to charge any other rates. *Infra*, p. 28. It by no means follows that all other rates are unlawful in the sense that they are unjust or unreasonable. Reasonableness in

26. *Ibid.*

27. This assumption is nowhere specifically stated, but is made at Pet. Br. 4-5, 9, 10, 13-15, 16, 18, 19.

rate-making is not a pinpoint but a zone. *Montana-Dakota Utilities Co. v. Northwestern Public Service Co.*, 341 U.S. 246, 251. The Commission may pinpoint the actual rates at any level within the zone of reasonableness. It may, but need not, allow the natural gas company something more than the lowest reasonable rate. It need not, but it may, set rates at the very "brink of confiscation." *City of Detroit v. FPC*, 230 F.2d 810, 815, cert. denied 352 U.S. 829.

It does not, therefore, follow that when the Commission lowers filed rates, the rates were unlawful when filed. They may well have been within the zone of reasonableness. The Commission would still have power to order them decreased, since § 4(e) gives it power to make "such orders with reference thereto as would be proper in a proceeding initiated after [the rates] had become effective," and § 5(a) gives it power to lower any but "the lowest reasonable rates."

Petitioner's entire claim — which is not that the rates are unreasonable, but only that they "may be" so — rests on the language of the Commission's suspension order. Pet. Br. 12-13, 14. Petitioner terms this language a "finding" of the Commission, and would have the Court infer that it is thereby authoritatively established that something may be wrong with the new rates. Nothing could be farther from the fact. The Commission always includes such language in suspension orders, but it has specifically repudiated the idea that suspension of a rate increase implies a disapproval of it, or in any way suggests that it will not eventually be allowed in part or in whole. *Virginia State Corp. Com'n*, 9 P.U.R. 3d 281, at 286.

When a natural gas company files with the Commission a new rate schedule under § 4(d), the Commission may do any one of four things:

(1) It may waive the requirement of thirty days' notice, and permit the new rate schedule to become effective immediately.

(2) The Commission may do nothing, in which case the new

rate schedule would become effective at the end of the thirty days' notice period, as specified by the natural gas company.

(3) It may, without suspending the rate schedules, decide to hold a hearing upon the question whether the new rates are just and reasonable.²⁸

(4) It may decide to hold a hearing on the lawfulness of the new rate, and suspend the operation of the new rate schedule for any period from one day up to five months.

The choice of these alternatives is purely discretionary with the Commission. *Virginia State Corp. Com'n*, 9 P.U.R. 3d 282-286. If it adopts the fourth, it may also order that when the new rate goes into effect (as it must be permitted to do when the suspension period, whether five months or less, expires) the collection of the increase shall be subject to refund to the extent it is later found by the Commission not justified. However, the only increase with respect to which a refund can be ordered is one which has been suspended. § 4(e); *Mobile Gas Service Corp.*, 12 F.P.C. 1422, 1424. The Commission has no power to suspend an *initial* rate; it can only suspend rate *changes*, § 4(e), and initial rates are reviewable only under § 5(a). See *Atlantic Refining Co. v. PSC*, 360 U.S. 378, 392; *Bel Oil Corp. v. FPC*, 255 F.2d 548, 554, cert. denied, 358 U.S. 804. So in the case of every initial rate, and also in the case of rate changes if notice is waived (alternative 1); or if the Commission takes no action on the natural gas company's notice of rate increase (alternative 2), or even if the Commission decides to hold a hearing without suspension (alternative 3), there is no possibility of its ordering a refund, even should the Commission later hold that the rates being collected were not just and reasonable, and therefore (prospectively) "unlawful".

The Commission may, and often does, adopt one of the first three alternatives *without* finding the new rate just and reasonable.

28. In this event, the rate schedules would become effective as specified by the natural gas company, and the effect of such an order would be no different than if the order were entered under § 5(a).

The Commission has held, and its regulations provide, that the acceptance of a schedule for filing is not an approval of the rate. *Home Gas Co.*, 2 F.P.C. 402, 409; *City of Cleveland v. Hope Nat. Gas Co.*, 3 F.P.C. 150, 187; *Dorchester Corp.*, 11 P.U.R. 3d 189, 191; 18 C.F.R. 154.23, 154.101. Thus, either an initial rate or a new rate schedule may become effective without suspension, without possibility of refund, and subject to a later finding that it is "unlawful"; yet it is not unlawful until such a finding is made. Far from it: the rate set forth in a filed and effective schedule is not only *a* lawful rate, but *the only lawful rate*. The buyer has no right to service by paying, and the seller has no right to demand or receive, any rate either less or more than the filed rate.²⁹ *The parties "can claim no rate as a legal right that is other than the filed rate, whether fixed or merely accepted by the Commission, and not even a court can authorize commerce in the commodity on other terms."*³⁰ Not only does the natural gas company commit no unlawful act by collecting the filed rate, but it would be unlawful for it not to do so. Petitioner's "property" is not "taken" when it pays only that which it lawfully owes.

After contending that the new rates "may be" unreasonable—a contention unsupported by findings or even evidence, entirely hypothetical, and not before this Court in any event—petitioner asserts that it has been deprived by the Natural Gas Act of a right to recover "unlawful" payments, and that no alternative remedy has been provided.

It is clear from *Montana-Dakota Utilities Co. v. Northwestern Public Service Co.*, 341 U.S. 246, cited by petitioner, that the Natural Gas Act (the provisions of which are wholly analogous

29. Subject, of course, to the *Mobile* exception: that the seller has not contracted away its right to file new rate schedules.

30. *Montana-Dakota Utilities Co. v. Northwestern Public Service Co.*, 341 U.S. 246, 251 (under § 205(a) of the Power Act, emphasis ours); *Hope Natural Gas Co. v. FPC*, 134 F.2d 287, 311 (under the Gas Act), reversed on other grounds, 320 U.S. 591.

to the Power Act in this regard) did *not* deprive buyers of a right to reparation for unreasonable rates, but rather that *no such right*, cognizable by the Federal Courts, *exists*. The dissenters argued that the Federal Power Act had created a right to a reasonable rate, for which the courts should provide a remedy. There was no suggestion in the opinion of the Court, or in the dissent, of any right to a reasonable rate other than one which might have been, *but was not*, created by Congress.³¹

Assuming, however, that the purchaser of natural gas had some common law remedy to obtain reparations in the event he paid a seller an exorbitant price for his product, it would not offend due process for Congress to abolish that remedy unless Congress thereby deprived petitioner of existing property or a right already vested. Indeed, the authorities cited by petitioner which are in point at all bear this out.³² Petitioner has not alleged that the Natural Gas Act deprived it of any of its property at the time of its passage. The record shows that all of the contracts in question were made after 1938. If petitioner wished to protect itself against increases in gas rates, it could have done so by contract. *United Gas Co. v. Memphis Gas Div.*, 358 U.S. 103. The Act deprived it of nothing.³³

31. *T.I.M.E. v. United States*, 359 U.S. 464, also relied upon by petitioner, did hold that *if* there had been a common law right to obtain reparations, it did not survive the enactment of the Motor Carrier Act. There is no suggestion that its abolition would raise any constitutional doubts. The majority of the Court questioned whether there had ever been a common law right to reparations for mere excessiveness of rates (as opposed to discrimination or fraud). In any event, no such right exists today, under the Motor Carrier Act, the Natural Gas Act, or the Federal Power Act.

32. Constitutional Law, 12 Am. Jur. 279, § 582, and Constitutional Law, 16A C.J.S. § 614, both cite cases which deal with the deprivation of vested rights by the abolition of judicial remedies.

33. It has in any event been held that the Act may validly be applied so as to alter rights under pre-1938 contracts. *J. M. Huber Corp. v. FPC*, 236 F.2d 550, 558, cert. denied 352 U.S. 971; *Colorado Interstate Gas Co. v. FPC*, 142 F.2d 943, 953, affirmed as to other issues, 324 U.S. 581; *Mississippi River Fuel Corp. v. FPC*, 121 F.2d 159, 163.

The fact is that Congress, by prescribing its system of regulation for the natural gas industry, has not deprived plaintiff of any judicial remedy it may have had to obtain reparations. What Congress *has* done is to change the substantive law. By declining to provide for a right to reparations, it has made clear that it intended no such right to exist.³⁴ The right of Congress, without violating the Constitution to make changes in the substantive law, cannot be doubted:

"A person has no property, no vested interest, in any rule of the common law. That is only one of the forms of the municipal law, and is no more sacred than any other . . . Indeed, the great office of statutes is to remedy defects in the common law as they are developed and to adapt it to the changes of time and circumstances."³⁵

The present state of constitutional law with respect to this subject was well summed up by the Court of Appeals, Sixth Circuit, in *NLRB v. Budd Mfg. Co.*, 169 F.2d 571, 578-79, cert. denied 335 U.S. 908, in which the question was whether supervisors were denied due process when the 1947 Labor Management Relations Act took away their federally-protected collective bargaining rights:

"It is equally well recognized that Congress has broad discretion in making statutory classifications, that such a classification is not invalid if it bears a reasonable relation to the purposes of the legislation, that legislative classification is presumed to rest on a rational basis if there is any conceivable state of facts which would support it, and that the courts will not inquire into the necessity of such classification if it is not patently irrational and unjustifiable There are numerous instances of valid legislation which has

34. *T.I.M.E. Inc. v. United States*, 359 U.S. 464; *Montana-Dakota Utilities Co. v. Northwestern Public Service Co.*, 341 U.S. 246.

35. *Munn v. Illinois*, 94 U.S. 113, 134; *Second Employers' Liability Cases*, 223 U.S. 1, 50; cf. *Battaglia v. General Motors*, 169 F.2d 254, cert. denied 335 U.S. 887.

classified and exempted certain types of employees from the provisions of the legislation being enacted.

"Whether it is desirable or undesirable, as a matter of policy, for foremen to organize and be classified as employees, is for Congress, not the Court, to determine.

"We do not agree with the further contention that the supervisory employees have been deprived of a property right in violation of the Fifth Amendment . . . There is no vested right in individuals to have the rules of law remain unchanged for their benefit . . . The Amendment is not directed against any named individuals or easily ascertainable members of a group. It expresses a policy, applicable to all within a general classification, not found to be either arbitrary or invalid; it is remedial public legislation rather than punitive to the individual. Congress was not interested in the activities of supervisors as individuals."

Both of the features of the Natural Gas Act complained of by petitioner—lack of Commission power to order reparations, and lack of Commission power to suspend industrial rates—were deliberately so included in the Act by Congress.³⁶ Basically, its

36. The Natural Gas Act, regulating interstate wholesales of gas, is based on Part II of the Federal Power Act, adopted in 1935, which regulates interstate wholesales of electricity. 16 U.S.C. 824d, 824e. The draftsmen of the Power Act had this to say about reparations, Sen. Rep. 621, 74th Cong. 1st Sess. 20:

"Section 205(b), transferred from section 202(c) of the original bill, has been modified. . . . The provisions defining with particularity the power of the Commission to investigate single rates and to fix standards of service . . . and the section authorizing the issuance of reparation orders . . . have been eliminated. They are appropriate sections for a State utility law, but the committee does not consider them applicable to one governing merely wholesale transactions."

In the drafting of the Gas Act, several of the bills completely exempted industrial gas from regulation. See, e.g., § 1(b) of H.R. 4008, 75th Cong., 1st Sess. It was recognized that industrial gas competed with other fuels, and no regulation was thought necessary. H.R. Comm. on Interstate and Foreign Commerce, Hearings on H. R. 11662, 74th Cong. 2d Sess. 17, 95. The bill which became the Act covered resales for industrial use, see H.R. 6586, 75th Cong. 1st Sess., but was amended to include the proviso in § 4(e) exempting industrial rates from suspension. Industrial users

reasons for both denials of power come down to this: the Act is not primarily designed as a distributor or industry-protection measure; if gas distributors and industrial users really need protection against rate increases, they can get it by contract; and if no contract can be agreed upon, other fuels are available to industry.

The difficulties and expenses attendant upon imperfection and lag in the regulatory process are not borne exclusively by distributors or industry, but are shared to an even greater extent by the pipelines. The pipelines are subjected by § 4 and § 5 to restrictions and disabilities similar to those § 4(e) places on industrial users. The pipeline cannot have any relief in a § 4 proceeding, where its new rates have been suspended, even though the old rates were too low during the suspension period; a pipeline cannot initiate a § 5 proceeding at all as a matter of right, and cannot get retroactive relief under either section. It has been held that there is no constitutional objection to these Congressional limitations on pipelines' rights. *Hope Natural Gas Co. v. FPC*, 196 F.2d 803, 808-09; cf. *State Corp. Com'n v. FPC*, 215 F.2d 176, 183.

• If in the interests of balancing the hardships of regulatory lag to which the pipeline is subject, Congress in its wisdom decided to require the industrial user of gas to share with the pipeline companies the burden of protecting the interests of the general public—a burden the industrial user can pass on to its own customers—it is manifestly reasonable for Congress to do so. The decision is for Congress to make, *NLRB v. Budd Mfg. Co.*, *supra*, and the courts will not strike down a system of federal regulation unless it is so patently unreasonable as to be oppressive

were left free to protect themselves by contract, as in the *Mobile* case. The distributor could protect itself in either of two ways: if it had a fixed-rate contract with the industrial customer, it could protect itself by a fixed-rate contract with the pipeline, as in *Mobile*; if it had a variable-rate contract with the pipeline, it could protect itself by escalation clauses in the industrial customer contracts, as in the *Memphis* case and this case.

and arbitrary. *Yakus v. United States*, 321 U.S. 414; *Carolene Products Co. v. United States*, 323 U.S. 18; *Wickard v. Filburn*, 317 U.S. 111; *Sunshine Coal Co. v. Adkins*, 310 U.S. 381; *United States v. Darby*, 312 U.S. 100; *Steward Machine Co. v. Davis*, 301 U.S. 548.

Petitioner contends that it is "as fully entitled to the protection of the Fifth Amendment as is" Pacific Northwest, since both are public utilities. Pet. Br. 17. The fact is, however, that petitioner sought and obtained exemption from the Natural Gas Act and is entirely free of federal regulation. *Pacific Natural Gas Co.*, 17 F.P.C. 638. Since the Fifth Amendment controls only federal action, petitioner's argument is irrelevant.³⁷

The Fifth Amendment does not guarantee petitioner a profit in its business any more than it guarantees such a profit to Pacific Northwest. *Alaska Fish Co. v. Smith*, 255 U.S. 44, 48. Consequently the fact—even if it were a fact—that petitioner might be required to absorb the increase of Pacific Northwest's rates, though important insofar as petitioner's standing to challenge the order is concerned (*Natural Gas Pipeline Co. v. FPC*, 253 F.2d 3), is of no relevance to the alleged infringement of its constitutional rights by the Natural Gas Act.

The relevant fact is that petitioner has consented to the rate increases by contract and cannot complain. There is no constitutional objection to the enforcement of obligations created by contract, even though the contract fails to reserve what otherwise would be a constitutional right. *Beall v. New Mexico*, 16 Wall. 535, 539-40; *United States v. American Fruit Product Corp.*, 238 U.S. 140, 142; cf. *Hickok Oil Corp. v. Fleming*, 161 F.2d 199, 202.

37. For this reason, we agree that it does not serve petitioner's "purpose in referring to the many decisions of the Supreme Court of the United States which are cited to support," Pet. Br. 18, the text quoted from *American Jurisprudence*. Without exception they set forth the minimum requirements of due process to which the *regulated utility in question* is entitled; but here petitioner's rights, if any, are those of any other purchaser of gas, not of a utility.

Even were petitioner, with respect to this case, in the position of a regulated utility, the same rule would apply. When rates are established by contract, no constitutional right is violated by enforcement of the contract; the question whether the rate is "confiscatory" is immaterial. *Southern Utilities Co. v. Palatka*, 268 U.S. 232; *Milwaukee Elec. Ry. Co. v. Milwaukee*, 252 U.S. 100, 105; see *Southern Iowa Elec. Co. v. Chariton*, 255 U.S. 539, at 542. "A public utility cannot, because of loss, escape obligations voluntarily assumed." *Fort Smith Traction Co. v. Bourland*, 267 U.S. 330, 332. A case very close on its facts to this one is *Arkansas Gas Co. v. Railroad Com'n*, 261 U.S. 379, in which the Legislature empowered the Commission to fix rates, but specifically withheld power to alter existing rate contracts, even though unjust and unreasonable. A unanimous Supreme Court had no difficulty overruling the due process objection.

The constitutional principle goes even further: there would be no violation of due process if governmental action required petitioner to pay a rate *higher* than that fixed in a contract. *Midland Realty Co. v. Kansas City Power Co.*, 300 U.S. 109. This being true, there can be no valid objection to enforcement of the contract.

Petitioner's fear that unless its claims are upheld, the seller can file repeated and successive rate increases, which the Commission will have no power to prevent, is a chimera. The Commission has already shown that it knows how to deal with that kind of tactic, by rejecting out of hand rate increases that are patently unjustified, or which depend for their reasonableness upon issues already decided against the seller; and the Commission in so doing has been upheld by the Courts of Appeals. *Northern Natural Gas Co.*, 11 F.P.C. 278, affirmed sub nom. *State Corp. Com'n v. FPC*, 206 F.2d 690, 715-16, 723; s.c. on further proceedings, 215 F.2d 176; *Panhandle Eastern Pipe Line Co. v. FPC*, 236 F.2d 606.

b. The Constitutionality of the Natural Gas Act Is Thoroughly Settled.

The Natural Gas Act is now more than twenty years old and has at all times contained precisely the provisions of which petitioner complains. Constitutional attack on the Act came shortly after its passage, the principal case upholding it being *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, where the Court said, p. 582,

"It is no objection to the exercise of the power of Congress that it is attended by the same incidents which attend the exercise of the police power of a State. The authority of Congress to regulate the prices of commodities in interstate commerce is at least as great under the Fifth Amendment as is that of the States under the Fourteenth to regulate the prices of commodities in intrastate commerce."

It is true that no one has yet been so temerarious as to make the precise constitutional argument which is here made by petitioner. Nevertheless, the constitutionality of the Act has been too often decided to leave room for doubt that it is valid in all its parts. *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575; *Mississippi River Fuel Corp. v. FPC*, 121 F.2d 159; *Thatcher v. Tennessee Gas Transmission Co.*, 180 F.2d 644, cert. denied 340 U.S. 829; *Williams v. Transcontinental Gas Pipe Line Corp.*, 89 F. Supp. 485. In October Term, 1944, the Supreme Court refused to hear a contention that the Act violated due process in overriding pre-1938 contracts, limiting its grant of certiorari in *Colorado Interstate* to other questions presented, 323 U.S. 700.

The same arguments made here (although without the constitutional overtones petitioner gives them) were rather summarily rejected by the Supreme Court in the *Memphis* case. Indeed, the brief for the respondents in that case went into great detail in arguing the facts of *this* very case, in an attempt to show that it is unreasonable to permit nonsuspendible and nonrefundable

increases in industrial rates to be made and filed by natural gas companies.³⁸ The Supreme Court answered,

“the force of respondents’ contention is wholly destroyed by the fact that it appears that the buyer-signatories to the agreements are entitled by contract with their customers to pass on any rate increases effected by United.”³⁹

And so here, the force of petitioner’s contentions is destroyed by the admitted fact that it does not bear any industrial rate increases but passes them on to its customers. *Infra*, pp. 37-38.

c. The Constitutional Claims Are Irrelevant.

The judicial policy of refusal to decide constitutional issues in the absence of “strict necessity” is well-known and thoroughly

38. Brief for Memphis Light, Gas & Water Div., et al., pp. 69-71, *United Gas Pipe Line Co. v. Memphis Light, Gas & Water Div.*, Nos. 23, 25, and 26, October Term, 1958, 358 U.S. 103.

39. The entire answer is as follows, 358 U.S. at 115-16, note 10:

“Respondents argue that the ‘effective superseding rate’ clause of the agreements must be read as referring only to superseding rates established after a § 5(a) proceeding, because it would be unreasonable to find that the buyer-signatories to the agreements had intended to authorize United to change its ‘industrial’ rates by a § 4(d) filing in light of the fact that such rates are not subject to suspension and refund under the statute. Apart from the circumstances that (1) United’s ‘industrial’ sales under these agreements appear to have been a relatively minor factor; (2) the clause would be entirely superfluous if construed as respondents would have it, since as a matter of law rate changes ordered by the Commission after a § 5(a) proceeding would have been incorporated into the agreements, *Northern Pacific R. Co. v. St. Paul & Tacoma Lumber Co.*, 4 F.2d 359 (C.A. 9th Cir. 1925), appeal dismissed, 269 U.S. 535; *Market Street R. Co. v. Pacific Gas & Electric Co.*, 6 F.2d 633 (D.C. N.D. Cal. 1925), appeal dismissed, 271 U.S. 691; and (3) the ‘industrial’ rates of United have consistently been below its other rates, the force of respondents’ contention is wholly destroyed by the fact that it appears that the buyer-signatories to the agreements are entitled by contract with their customers to pass on any rate increases effected by United. Under these circumstances it can hardly be said to be inconceivable, or even unlikely, that the buyers would have been willing to authorize United to change its ‘going’ rates to them under § 4(d).”

established, and we do not stop to argue it.⁴⁰ One of the branches of this rule is that the constitutionality of a statute will not be decided "upon the complaint of one who fails to show that he is injured by its operation." *Coffman v. Breeze Corporations*, 323 U.S. 316, 324-25; *Morf v. Bingaman*, 298 U.S. 407, 413; *Plymouth Coal Co. v. Pennsylvania*, 232 U.S. 531, 544-45.

Petitioner ignores this rule, contending only that it has standing to petition for review under § 19(b) of the Act, and relying on *Natural Gas Pipeline Co. v. FPC*, 253 F.2d 3. Pet. Br. 19.

But the question whether one has standing to petition for review under the Act, and whether he has standing to allege the unconstitutionality of the Act, are very different questions. As the case cited by petitioner shows, one may be said to be "aggrieved" by administrative action, and therefore be permitted to seek judicial review of it, although he is affected only in oblique and intangible ways, and is in fact asserting the interests, not of himself, but of others—even of the "public". See *Scripps-Howard Radio v. FCC*, 316 U.S. 4, 14; *FCC v. Sanders Bros. Radio Station*, 309 U.S. 470, 476-77.

Not so, however, in constitutional litigation. There the litigant must show that he, himself, is the injured party. In point is *Newark Natural Gas Co. v. Newark*, 242 U.S. 405, holding that a gas distributing company could not complain of an ordinance fixing resale rates for gas, where the purchase price of the gas was fixed by contract at a percentage of the resale rate; for the distributor "cannot be heard here to assert the constitutional rights of" its vendor. See also *Tileston v. Ullman*, 318 U.S. 44, and cases cited.

Petitioner all but concedes that all rate increases established by Pacific Northwest have been passed on to petitioner's customers. Pet. Br. 18. It does not deny, in any case, that that is the

40. *Rescue Army v. Municipal Court*, 331 U.S. 549, 568-75; *Alma Motor Co. v. Timken-Detroit Axle Co.*, 329 U.S. 129, 136-37; *Spector Motor Service v. McLaughlin*, 323 U.S. 101, 105.

fact, and therefore “fails to show that [it] is injured” by the alleged unconstitutional action. Indeed, petitioner could hardly deny that it has passed on all of the rate increases, since the record contains its statements that it fully intended to do so; it refers, R. 752, to “the fact that Pacific Natural Gas Co. . . . [is] unable to absorb the proposed rate increase and will be required to pass it on to its customer consumers . . .” Again, it concedes, R. 753, that all of its industrial contracts except one contain escalation provisions, and in the case of that one, it will seek an increase from the Washington Public Service Commission. And its customers themselves—all of them who refer to the subject at all—contend that their contracts with petitioner “provide that increased gas costs suffered by the distributor are to be passed on to the purchasers.” R. 1257.⁴¹

Petitioner seeks to avoid the application of this settled rule on the basis that it is “contrary to fundamental right and justice” to require petitioner to impose “unlawful rates” upon its customers. Pet. Br. 18. But such an argument assumes that the rates *are* “unlawful.” There is nothing in the record, or in the brief for that matter, to suggest that the rates are unreasonable, or will ever be held unlawful; and as we have shown, unless and until they are so held, they are not merely lawful rates, but the *only* lawful rates. *Supra*, p. 28. There is nothing contrary to right or justice in recognizing that petitioner is suffering no harm by reason of the facts it alleges, and in requiring that the claims of unconstitutionality be presented, if at all, by those who can show injury to themselves. On the contrary, a firmly-embedded policy of judicial restraint demands that until a petitioner appears who does show injury to himself, no claim of violation of the Constitution be entertained.

Application of the rule of “strict necessity” for decision of constitutional questions means, of course, that no Federal Court

41. Two of the ten parties to the cited document alleged they are customers of petitioner. R. 1260, 1264.

should reach a constitutional issue unless the case cannot be disposed of in any other way. E.g., *Alma Motor Co. v. Timken-Detroit Axle Co.*, 329 U.S. 129, 136-37. Here, however, decision of the constitutional questions raised by petitioner could not affect the result *at all*, for even if they could somehow be decided in petitioner's favor, it would not follow that the order under review should be reversed, or that petitioner could be granted the relief it seeks.

The order sought to be reviewed is simply one which denies a motion by the petitioner to reject Pacific Northwest's changed rate schedules. It fixes no rates and denies no reparations. The rate schedules involve several kinds of service, domestic and commercial as well as industrial. They alter the rates for service not only to this petitioner, but to all of Pacific Northwest's customers who take the particular service, and there are many such customers under each rate schedule. They apply not only pending the Commission's hearing and order, but for the indefinite future unless changed pursuant to law.

The contractual provisions permitting Pacific Northwest to make and file new rate schedules are valid and enforceable. *Memphis*, 358 U.S. 103. Petitioner's constitutional objections go only to the right of Pacific Northwest, pending Commission review, to collect increases in rates for industrial gas alone, for a temporary period, from the present petitioner.

The constitutional claims do not go to the validity of the *contract*, since a contract can hardly be unconstitutional. But even if the rate-changing term of the contract were somehow invalid, the result would simply be a binding contract without any price term, but subject to the Act and to Commission regulation. In that case, there being nothing in the service agreement which sets a fixed rate, Pacific Northwest would have the usual right of every natural gas company not bound to a fixed rate, to make and file new rate schedules. *Mobile*, 350 U.S. 323; *Memphis*, 358 U.S. 103. A determination that the contract was invalid would in no

way affect the rights of the parties, and certainly would not affect the powers of the Commission.

As before shown, the contention that the Act is unconstitutional has two negative aspects: it goes not to the validity of anything Congress has done, but only to the failure of Congress to regulate to the limit of its power; and it does not go to the validity of the rate increase filing as the basis for permanent rates, but only to their validity in the interim period between filing and an order after hearing. Pet. Br. 4-5. There is thus no real basis whatever for any contention that this Court could or should order the Commission to *reject* the new rates *in toto*. The entire filing cannot be rejected on the supposition that it may turn out to be unjustified in part. *Mississippi River Fuel Corp. v. FPC*, 202 F.2d 899, 902. The Commission clearly has jurisdiction to review the rates and continue them in effect after hearing if they are found just and reasonable, and no constitutional objection to its doing so has been suggested. The objection is merely that it failed to suspend them in the meanwhile.

But the reason that the Commission did not suspend the industrial rates is that the Congress specifically withheld from the Commission the power to do so. § 4(e), *proviso*. It would seem clear that this Court could not grant to the Commission a power of refund and suspension that the Congress has deliberately withheld. And yet, that is all the petitioner really asks, or has even the slightest color of claim to ask the Court to do.⁴² On the other

42. As noted above, an initial rate cannot be suspended, and the exercise of the power to suspend nonindustrial rates is only one of four options the Commission has when rate changes are filed. *Supra*, p. 26. None of the other three options involves any suspension, and when there is no suspension there can be no refund. It may also be noted that the Commission cannot award retrospective rates to a natural gas company in a § 5(a) proceeding where the rates turn out to be too low. A holding that a total lack of power to suspend industrial rates is unconstitutional would seem also to require holdings:

- (a) That it is unconstitutional to fail to suspend initial rates;
- (b) That when rate changes are filed, it is unconstitutional for the Commission to waive notice as the Act expressly permits;

hand, invalidity alleged to lie in the failure of Congress to grant a right to restitution of payments made during the period between effectiveness of rate changes and the date of an order fixing rates, is a subject not before the Court. There is no finding that any rate is unjust or unreasonable, no showing that petitioner is in any way harmed. Only a hypothetical case is presented. *United States v. Harriss*, 347 U.S. 612, 617; *United States v. Petrillo*, 332 U.S. 1, 11-12. Petitioner's complaint necessarily rests upon the assumption that the filed rate for industrial gas, which the agreement currently requires petitioner to pay, will later be held unreasonable. Only the Commission can decide that question in the first instance, see *Montana-Dakota*, 341 U.S. 246, 251, and it has not yet held a hearing or reached a decision. It may well hold that the filed rates are just, reasonable and lawful. If it does, petitioner's complaint vanishes. The Court could not very well grant petitioner relief here upon the assumption, unsupported by findings or even evidence, that the Commission will outlaw the filed rate. So to do would necessarily intrude upon the Commission's primary jurisdiction to decide "issues which, under a regulatory scheme, have been placed within the special competence of an administrative body," *United States v. Western Pacific R. Co.*, 352 U.S. 59, 64, as well as requiring an advisory opinion upon a constitutional question not ripe for adjudication, *United States v. Harriss*, *supra*. Even if the Court were somehow brought to agree with petitioner's Constitutional arguments, the result could not

(c) That it is unconstitutional for the Commission to do nothing when rate changes are filed, as the Act tacitly permits;

(d) That it is unconstitutional for the Commission to order a hearing without suspension or refund;

(e) That it is unconstitutional to fail to award the seller company suspension, refunds and reparations in § 5(a) proceedings, but see *Hope Natural Gas Co. v. FPC*, 196 F.2d 803.

This, of course, would leave very little of §§ 4 and 5 standing, would cut out "the heart of the new regulatory system", *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 611, and thereby destroy what both Congress and the Supreme Court have considered to be a "comprehensive and effective regulatory scheme." *Atlantic Refining Co. v. PSC*, 360 U.S. 378, 392.

rationally be either a judicial grant of power to the Commission to fix or order reparations, or a judgment that the Commission be stripped of all of its jurisdiction conferred by Congress over industrial rates, a portion of which must be conceded to be valid. *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581, 595-96.

Thus, petitioner's constitutional claims present to this Court no case with respect to which the Court could properly grant any relief, even if the constitutional objections were sound. As shown above, if the constitutional claims are reached, they will be found to be utterly lacking in substance or merit.

CONCLUSION

Petitioner's claim as to the meaning of the service agreements—unsupported by evidence and unshared by any other of several dozen parties to the same agreements—is foreclosed by the uncontradicted findings of the Commission, and by the *Memphis* case. That is really all there is to petitioner's case. Its constitutional claims are both irrelevant and baseless. The order of the Commission should be affirmed.

Respectfully submitted,

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October 26, 1959

No. 16498

**In the United States Court of Appeals
for the Ninth Circuit**

PACIFIC NATURAL GAS CO., A CORPORATION, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

BRIEF FOR RESPONDENT FEDERAL POWER COMMISSION

Upon Review of Order of Federal Power Commission

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In the United States Court of Appeals for the Ninth Circuit

No. 16498

PACIFIC NATURAL GAS CO., A CORPORATION, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

BRIEF FOR RESPONDENT FEDERAL POWER COMMISSION

Upon Review of Order of Federal Power Commission

STATEMENT OF JURISDICTION

This is a proceeding to review an order of the Federal Power Commission issued on February 25, 1959 (R. 1372-1374). Petitioner's application for reconsideration, filed on March 18, 1959 (R. 1375-87), which may be treated as application for rehearing, is deemed to have been denied on April 17, 1959, since the Commission had not acted upon it at that time.¹ Section 19(a) of the Natural Gas Act, 15 U.S.C. 717r(a) *infra*, p. 33.¹ The petition for review was filed on June 12, 1959. Jurisdiction of this Court rests upon Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r (b) *infra*, p. 33.

¹ The Commission issued an order denying the motion for reconsideration on July 23, 1959 (R. 1409-1412), prior to the certification of the record to this Court.

STATEMENT OF THE CASE

Pacific Northwest Pipeline Corporation, which is an interstate pipeline company and subject to regulation by the Federal Power Commission as a "natural-gas company" within the meaning of the Natural Gas Act, transports and sells natural gas in interstate commerce for resale to the petitioner Pacific Natural Gas Company under a rate tariff on file with the Federal Power Commission and several service agreements which incorporate by reference the price provisions of the tariff as well as its general terms and conditions.

In August 1957, Pacific Northwest filed with the Commission revised rate schedules increasing the prices provided by its tariff which governed its sales to petitioner. The primary question presented here is whether or not the Commission had "jurisdiction" to accept for filing revised rate schedules relating to sales for resale for industrial use only and to appraise the reasonableness of the increased rates under Section 4, *infra*, p. 29, of the Natural Gas Act.

A brief summary of the Commission's gas rate filing procedure provides a necessary introduction.

1. The Commission's rate filing procedures

When the Natural Gas Act was enacted in 1938, the Commission permitted the natural-gas companies subject to its jurisdiction to file their existing sales contracts as rate schedules so that the contract rates became the effective legal rates. These contracts had been individually negotiated with each purchaser, with the result that the contracts, and the rates defined therein, varied greatly in amount as well as form.

Shortly after the Act's passage, the Commission initiated a program of system-wide tariffs to provide uniform rates for all of a system's equivalent sales and to eliminate discrimination among its customers. To that end, the Commission, in August 1940, circulated among the pipeline companies for comment "Tentative Instructions for Preparing and Filing F.P.C. Rate Schedules" under which the contractual rate schedules would be converted to prescribed tariff forms. The advent of World War II made it impossible to go forward with this undertaking; however, a substantial number of pipeline companies cooperated with the Commission by voluntarily converting their rate forms from contracts to tariffs.²

Thereafter, in April 1948, the Commission, noting that the experience under the voluntary conversions demonstrated "the feasibility and desirability of such a change and that benefits and advantages may be expected to result to the public and natural gas companies" (13 Fed. Reg. 2046), again proposed amendment of its rate regulations to establish the tariff system. 13 Fed. Reg. 2045-2050. Upon receiving suggestions and comments from interested persons, the Commission revised the proposed regulations and again invited comments. 13 Fed. Reg. 5214. After the receipt of further suggestions, the Commission made additional revisions in the proposed regulations

² Prior to this conversion, the companies had on file with the Commission separate rate schedules consisting of almost 7,000 pages. The substituted tariffs comprised only 388 pages. See 13 Fed. Reg. 6371.

and, in October 1948, issued the regulations as Order No. 144. 13 Fed. Reg. 6371 *et seq.*³

Order No. 144, which has been in effect since that time and which (with a few minor amendments not here relevant) is still operative (18 C.F.R. 154.1 *et seq.*),⁴ requires the conversion of all rate contracts into tariff-and-service-agreement form, as well as the restatement of all rates in cents or in dollars and cents per unit.⁵

In a tariff-and-service-agreement method of rate making, unlike the earlier contracts, the buyer and seller do not agree in advance on a specific rate for a definite period of time through individual contracts tailored to a particular transaction. Rather, the seller files rate schedules of general applicability, stating the price at which it will sell gas to all its customers within a given zone or class. In addition, it enters into service agreements with its customers which provide

³ For further summaries of the history of Order No. 144, see 13 Fed. Reg. 6371-2; *United Gas Pipe Line Company*, 16 FPC 10, 12-13.

⁴ Order No. 144 now applies principally to pipeline companies, special provision having been made for independent producers by Commission regulations concerning the rates of the latter. 18 C.F.R. 154.91 *et seq.*

⁵ To meet special situations, however, the Commission reserved the right to permit the filing of contracts as rate schedules. See Section 154.52 of the order. In addition, under Section 154.85, a contract already on file as an effective rate schedule might be continued in effect as an executed service agreement to the extent that its provisions "are not superseded by or in conflict with other applicable provisions of the rate schedules and general terms and conditions of the tariff * * *." The only exception permitted to the requirement of restatement was where price provisions could not be restated without effecting a change in rates or charges. See Section 154.82.

for the amount of gas to be sold and the duration of the sale. These agreements do not contain a price term, but merely refer to the filed rate effective at the particular time or as it may be superseded.

Order No. 144 was generally accepted by all parts of the industry.⁶ As of December 1957, there were 1,100 service agreements⁷ filed with the Commission, compared to 141 other contracts of various types filed under Sections 154.52 and 154.85 of the Order (*supra*, p. 4).⁸

2. The pertinent agreement

The rate at which Pacific Northwest sells gas to petitioner for resale for industrial use only is governed by its Rate Schedule I-1 (R. 16), which is contained in Pacific Northwest's FPC Gas Tariff, Original Volume No. 1, originally filed in 1956. Pacific Northwest also filed as part of its tariff, as required by the Commission's regulations (18 C.F.R. 154.40), the form of service agreement which it employs in making sales subject to Rate Schedule I-1 (R. 39-41).

The service agreements between Pacific Northwest

⁶ Review of Order No. 144 was sought only by two customer companies. See *United Gas Pipe Line Co. v. F.P.C.*, 181 F. 2d 796 (CADDC), certiorari denied, 340 U.S. 827; *United Gas Pipe Line Co. v. F.P.C.*, DDC Civil Action No. 4680-50. The district court proceeding was dismissed as part of the settlement approved by the Commission in *United Gas Pipe Line Co.*, 13 FPC —, Op. No. 277, issued November 2, 1954.

⁷ The 1,100 service agreements include 80 pre-existing contracts, the price terms of which have been restated pursuant to Section 154.85 of the Commission's regulations, *supra*, p. 4, fn 5.

⁸ The 141 other contracts include 18 special sales contracts of the type involved in *Mobile, infra*, p. 7, the balance consisting of special agreements for gas transportation, exchange and storage, and operating arrangements.

and petitioner with respect to sales for industrial resale only, which were in effect on August 6, 1957, the time of the rate filing here at issue (R. 340-347),⁹ provided in part that (R. 342, 345) :

ARTICLE III—APPLICABLE RATE SCHEDULE

Buyer agrees to pay Seller for all natural gas service rendered under the terms of this agreement in accordance with Seller's Rate Schedule I-1 as filed with the Federal Power Commission and as such rate schedule may be amended or superseded from time to time. This agreement shall be subject to the provisions of such rate schedule and the General Terms and Conditions applicable thereto on file with the Federal Power Commission and effective from time to time, which by this reference are incorporated herein and made a part thereof.

The other service agreements between Pacific Northwest and petitioner, as well as those with the other jurisdictional customers of Pacific Northwest, contain the same provision except for a reference to the appropriate Rate Schedule in each instance (R. 1410).

Paragraph 10 of the General Terms and Conditions (R. 34), incorporated into the service agreements by reference, provides as follows :

Seller's rates, charges, classifications and services as set forth in this Tariff are subject to

⁹ The service agreement of May 3, 1957, for industrial interruptible gas only to which petitioner refers (Br. p. 5) is not an effective service agreement since it has not been "filed" by Pacific Northwest. See 18 C.F.R. 154.1, 154.22. But as the Commission noted (R. 1410), the effective service agreements contained identical provisions with respect to the applicable rate schedule.

regulation by the Federal Power Commission under the Natural Gas Act. Seller shall have the right to file from time to time with the Federal Power Commission under Section 4 of the Natural Gas Act such new rate schedules and changes in its existing effective Tariff as Seller may find necessary from time to time to assure Seller just and reasonable rates and charges as well as a rate of return sufficient to service the Seller's debt, attract capital, insure expansion and provide adequate natural gas service to all Seller's customers. Without in any way limiting the generality of the foregoing, Seller shall have the right to file new rate schedules fairly and appropriately reflecting changes in the rates and charges paid by Seller for natural gas. Buyer shall have the right to protest any such new rate schedules and changes before the Federal Power Commission.

3. The proceedings before the Commission

On August 6, 1957, Pacific Northwest filed with the Commission revised Rate Schedules whereby it sought to increase all of its rates, including those governing its sales to petitioner. Following its usual practice, the Commission by a letter dated August 7, 1957, requested petitioner's comments on the revised schedules. Petitioner responded to this request urging that the revised schedules be suspended (R. 751). This response did not dispute the Commission's jurisdiction over the rate schedules under Section 4 of the Natural Gas Act, 15 U.S.C. 717c, as construed in *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332, since they did not challenge the

filings under *Mobile*. The Commission, on September 4, 1957, partly in response to this request, ordered a hearing to be held on the lawfulness of the proposed rate changes and suspended all of the revised schedules, except those relating to sales for resale for industrial use only (R. 817).¹⁰

Thereafter, on January 21, 1958, petitioner, relying solely on the decision of the Court of Appeals for the District of Columbia Circuit in *Memphis Light, Gas and Water Division v. F.P.C.*, 250 F. 2d 402 (decided November 21, 1957), reversed *sub nom. United Gas Pipe Line Co. v. Memphis Light, Gas and Water Division*, 358 U.S. 103, asked the Commission to reject for filing Pacific Northwest's revised tariff sheets applicable to sales to it (R. 1062-1065). On April 28, 1958, upon proper motion by Pacific Northwest, the Commission ordered that the suspended rates become effective as of February 5, 1958, subject to Pacific Northwest's giving security to assure refund of the amount of the increased rate found not justified. In this order, the Commission stated it was not at that time passing upon the various motions, including petitioner's, to reject the revised rate schedules (R. 1219, 1220).¹¹ Following the Supreme Court's Decem-

¹⁰ Section 4(e) of the Natural Gas Act, 15 U.S.C. 717c(e), *infra*, p. 30, provides in part:

* * * That the Commission shall not have authority to suspend the rate, charge, classification, or service for the sale of natural gas for resale for industrial use only * * *.

¹¹ In addition to petitioner's, motions to reject Pacific Northwest's revised tariff sheets were also filed by Washington Public Service Commission, Public Utility Commission of Oregon, Public Service Commission of Utah, Mountain Fuel Supply Company, Public Service Company of Colorado, Washington

ber 1958 decision in *Memphis*, reversing the lower court and affirming the Commission's action, the Commission on February 25, 1959, denied the various motions to reject the revised schedules, finding that in the service agreements with its customers Pacific Northwest had reserved the right to make unilateral rate changes in accordance with the provisions of Section 4 of the Natural Gas Act (R. 1372). Petitioner's application for reconsideration of this order was denied (R. 1409).¹²

SUMMARY OF ARGUMENT

In the *Memphis* case, the Supreme Court held that a pipeline company may use the filed rate procedure of Section 4(d), *infra*, p. 30, of the Act to effect changes with respect to all its rates unless it has contracted away its right to change its rates unilaterally. The holding of this case is, we submit, dispositive here.

In Point I we show that the service agreement in this case is even more explicit in giving the seller the right to file rate changes under Section 4 than were the service agreements reviewed in *Memphis*. We also show that the purchaser's right to protest rate filings by Pacific Northwest is no greater than that of the purchasers of gas from the seller in the *Memphis* case.

Natural Gas Company, Coos Bay Pulp Corp., et al., and Kaiser Aluminum & Chemical Corp. (R. 1372-1373). Like petitioner's, these motions were filed prior to the Supreme Court's decision in *Memphis*, *supra*.

¹² There were no applications for rehearing or other motions for reconsideration of the order of February 25, 1959, denying the various motions to reject for filing Pacific Northwest's revised rate schedules.

In any event, petitioner's reservation of a "right to protest" is specifically directed at rate filings under Section 4(d) and hence subject to the limited powers of the Commission with respect to rates for resale for industrial use only under that section. Moreover, we show that petitioner's present construction of its service agreements with Pacific Northwest to give the same provisions different meanings depending on whether suspendible or non-suspendible rates are involved is inconsistent with petitioner's actions in this proceeding. Finally, we demonstrate that apart from the Natural Gas Act the pricing provision of the service agreement is enforceable and that even if the service agreement were unenforceable because of the pricing provision, the rate changes filed by Pacific Northwest were properly accepted since *ex parte* filings are sanctioned by Section 4(d) in the absence of a contract.

In Point II we show that the Natural Gas Act is not unconstitutional in permitting a seller unilaterally to file rate increases with respect to sales for resale for industrial use only. Petitioner's first contention that the statutory scheme denies it due process is based on the assumption that the Act deprives it of a right to recover unjustified charges from the seller. We show that, in the absence of the Act, the rate a seller of natural gas could charge was limited only by competitive conditions. Thus, any right of petitioner to pay rates that are just and reasonable stems from the Act. We show that, in these circumstances, petitioner cannot complain of a lack of due process because Congress chose not to permit the Commission

to make retroactive determinations with respect to the reasonableness of non-suspendible rates or to sanction recovery of reparations even though the rates might be found unjust and unreasonable prospectively. Petitioner's recourse is, we submit, to the Congress and not to the courts. Moreover, we show that petitioner was not, by statute, precluded from purchasing industrial resale gas from Pacific Northwest under a suspendible rate schedule but chose to risk the increase in rates since the non-suspendible rates were cheaper and because Pacific Northwest's rates increases, if any, would be passed on to its customers by petitioner.

ARGUMENT

Introduction

The Commission believes that the decision in the *Memphis* case *supra*, p. 8, is fully controlling here. Before showing that the distinctions petitioner seeks to draw are illusory, a brief statement of the *Memphis* case is necessary. In the *Memphis* case, the Supreme Court held that under the Natural Gas Act a pipeline company is not precluded from changing its rates by filing new rate schedules pursuant to Section 4(d) of the Act, unless it has contracted away the right to change its rates unilaterally. It rejected the lower court's determination (250 F. 2d 402) that the filing procedures prescribed by Section 4 (d) and (e) *infra*, p. 30, could be employed by a seller of natural gas only in those instances where the parties to the service agreement had by mutual consent agreed to a rate change of a specific amount.

The Court went on to hold that the Commission was fully justified in finding that under the service agreements involved in *Memphis* the seller had reserved the power unilaterally to make rate changes, subject to the procedures of Section 4 of the Act. The *Memphis* pricing provision provided (358 U.S. at 105) :

All gas delivered hereunder shall be paid for by Buyer under Seller's Rate Schedule (the appropriate rate schedule designation is inserted here) *or any effective superseding rate schedules* on file with the Federal Power Commission. This agreement in all respects shall be subject to the applicable provisions of such rate schedules and to the General Terms and Conditions attached thereto and filed with the Federal Power Commission which are by reference made a part hereof. [Emphasis added by the Court.]

The Commission had construed this provision as in effect constituting an undertaking by the purchaser to pay the seller's filed rates. In affirming this construction the Court said (358 U.S. at 114-115) :

It seems sufficient to say that the record shows that these agreements are typical of the "tariff-and-service" arrangements contemplated by Commission Order No. 144, CFR § 154.1 *et seq.*; that until this case no one connected with the industry seems to have thought that agreements of this sort precluded natural-gas companies from changing their rates in accordance with and subject to § 4 (d) and (e) procedures; and that the respondents' present contrary contentions had their sole genesis in a mistaken view of our decision in the *Mobile*

case. Beyond this, we find nothing in these agreements, as interpreted by the Federal Power Commission, which is hostile to any of the provisions or purposes of the Natural Gas Act.

Accordingly, the Court affirmed the Commission's refusal to reject for filing the new rate schedules filed by United Gas Pipe Line Company in September 1955 generally increasing its prices for gas, including that furnished under rate schedules for sales of gas for resale for industrial use only. As in this case, the Commission, acting under Section 4(e) of the Act, ordered a hearing as to the lawfulness of the proposed new rates, and, except as to those relating to sales for resale for industrial use only, suspended their effectiveness for the maximum five-month period permitted by the Act.

I. Pacific Northwest's service agreement with its purchasers authorized it to file changed rates under Section 4(d) of the Natural Gas Act

An examination of the relevant service agreement between Pacific Northwest and petitioner, which was in effect when the rate change with respect to sales of interruptible industrial gas was filed on August 6, 1957, leaves no doubt that Pacific Northwest had, under the terms of the agreement, reserved its right to file changed rates pursuant to Section 4 of the Natural Gas Act. For under Article III of that service agreement petitioner agreed to pay Pacific Northwest "in accordance with Seller's Rate Schedule I-1 as filed with the Federal Power Commission and as such rate schedule may be amended or superseded from time to time". *Supra*, p. 6. And paragraph 10

of the General Terms and Conditions, *supra*, pp. 6-7, which is incorporated by reference into the service agreement, states that the "Seller shall have the right to file from time to time with the Federal Power Commission under Section 4 of the Natural Gas Act such new rate schedules and changes in its existing effective tariff as Seller may find necessary" to meet certain conditions.

The sufficiency of this language to reserve to Pacific Northwest the right to file changes with the Commission is emphasized by the fact that the contractual language in *Memphis*, *supra*, p. 12, found sufficient to reserve to the seller the right to make unilateral rate filings was much less explicit than the language here. Indeed, it was limited to a provision no more specific than the language of Article III of the service agreement here involved standing alone. Nevertheless, petitioner argues that the service agreement should not be construed to permit Pacific Northwest to file rate changes with respect to non-suspendible industrial resale rates under Section 4 of the Act because of the further provision in paragraph 10 of the General Terms and Conditions that the "[b]uyer shall have the right to protest any such new rate schedules and changes before the Federal Power Commission" (Pet. 10-11). It contends that this provision distinguishes this case from *Memphis* where such an express provision was not present (Pet. 19) and urges that this right to protest rate changes has no meaning with respect to non-suspendible rate changes so that "by necessary implication" Pacific North-

west's reservation to make rate changes cannot apply to such rates (Pet 10-11). Petitioner fails to acknowledge, however, that under the Commission's interpretation of the service agreement the buyer, by invoking its "right to protest," may persuade the Commission to order decreases in the non-suspendible rates for the future.¹³

Although the purchasing distributing companies in the *Memphis* case had not *expressly* reserved the right to protest before the Commission rate changes filed by the seller, that fact does not make *Memphis* any less controlling here. In the first place, the Commission in the *Memphis* proceedings found that the right of the purchasers in that case to complain of rate increases had not been waived by the service agreements permitting the seller to file rate changes, subject only to Commission review under Section 4 of the Act. See *United Gas Pipe Line Co.*, 16 FPC 19, at 23, 25.¹⁴

¹³ Petitioner cannot successfully contend that even if its protest persuades the Commission to find an increased rate unreasonable and to order a lower rate a seller could immediately file a new rate schedule, which would go into effect after the thirty-day notice period, at the level previously rejected or even a higher one. For, absent a showing of a substantial intervening increase in its costs, petitioner's new filing would be subject to summary disposition. See *Panhandle Eastern Pipe Line Co. v. F.P.C.*, 236 F. 2d 606 (CA 3); *State Corporation Commission of Kansas v. F.P.C.*, 206 F. 2d 690, 715 (CA 8), certiorari denied, 346 U.S. 922.

¹⁴ The Commission's regulations provide (18 C.F.R. 154.27):

"Comments of any purchaser or other interested party concerning any filing made pursuant to this part should be submitted within 15 days after the date of filing. This section shall not limit any right to file protests and complaints."

Second, the purpose of the right to protest accorded to petitioner in this case can only be to negate any possible contention by Pacific Northwest that petitioner had waived its right to protest the justness and reasonableness of changed rates. For it is, of course, clear that the parties to a private contract have no power to confer on each other rights before the Commission which are not afforded by statute or regulation.

Moreover, petitioner's construction of paragraph 10 of the General Terms and Conditions ignores the fact that the right to protest reserved therein is a reservation made in the context of Section 4 of the Act. For the right to protest is reserved only with respect to "any *such* new rate schedules and changes" [emphasis supplied]. This is necessarily a reference back to the preceeding two sentences of the General Terms and Conditions which necessarily contemplate unilateral Section 4 rate filings by Pacific Northwest, since no other type of rate change is referred to in the paragraph. And while a determination by the Commission that an increased industrial gas rate is unjust and unreasonable can provide petitioner prospective relief only because of the Commission's inability to suspend such increased rates, to require refunds or to award reparations, the right to protest reserved to petitioner by paragraph 10 permits it to seek at least such prospective relief and cannot be said to be meaningless, within the existing statutory scheme to which the "right to protest" was addressed. It should also be observed here that while, with respect to rates for industrial resale gas only, the Com-

mission's interpretation of paragraph 10 gives meaning to all parts of that provision, petitioner, to give greater significance to its right to protest rate changes, would deprive the equally explicit right of the seller to file changes in rates of all meaning.

In addition, if Pacific Northwest and petitioner, at the time they entered into their service agreement relating to sales for resale for industrial use only, had believed that the rate change provisions of paragraph 10 of the General Terms and Conditions were not intended to relate to such non-suspendible changes, such an intent could easily have been manifested by specifically excluding those provisions from the incorporation by reference in Article III of the service agreement.

Moreover, the fact that the contract construction now urged by petitioner does not reflect a contemporaneous view of the contract is also evidenced by petitioner's action in these proceedings. Thus, when petitioner originally protested the rate increases proposed in August, 1957, petitioner did not even suggest that the Commission should reject the filed increased rates but urged only that they were unjust and unreasonable and should be set down for hearing (R. 751). After the Commission had ordered a hearing on Pacific Northwest's increased rates, petitioner filed a Motion to Intervene, but again did not suggest that any of the rate schedules should be rejected for filing. Only after the decision of the Court of Appeals for the District of Columbia in the *Memphis* case¹⁵ did

¹⁵ *Memphis Light, Gas & Water Division v. F.P.C.*, 250 F. 2d 402.

petitioner urge the Commission to reject Pacific Northwest's rate changes for filing. When the Commission denied this motion, and the comparable motions of other interested persons after the Supreme Court's decision in *Memphis*, petitioner, in seeking reconsideration, for the first time urged that none of the rate schedules applicable to its rates should have been accepted for filing because of its right to protest. And while it did suggest that with respect to the increases in rates for industrial resale use only there were constitutional infirmities, petitioner did not even at that time suggest that the provisions of paragraph 10 were open to two constructions—one for service agreements relating to resales for industrial use only and a different one for all other sales. Not until its brief was filed in this Court, did petitioner suggest this split personality for paragraph 10.

Petitioner's course of conduct shows that its present construction of the contract is a mere after-thought. This is confirmed by the failure of any of the interested state commissions or other purchasers from Pacific Northwest to urge such a construction or even to file applications for rehearing of the Commission's order denying their motions to reject Pacific Northwest's rate increase filings which, like petitioner's motion, had been based principally on the Court of Appeals decision in *Memphis*. This failure also shows that, except for petitioner, the other purchasers under service agreements with Pacific Northwest, as well as the state commissions, accept the Commission's view

that the Supreme Court decision in the *Memphis* case is dispositive of the present case in all respects.

The foregoing conclusions are in no way affected by petitioner's contention that, if the service agreement is construed as permitting unilateral rate filings under Section 4 with respect to sales for resale for industrial use only, the price condition of the service agreement would be unenforceable since it would permit Pacific Northwest to establish prices entirely at its will (Pet 11).¹⁶ For while the cases and other authorities do support the proposition that a price conditioned entirely on the will of one of the parties cannot be enforced, it is clear that an agreement to pay whatever price, generally applicable to all purchasers of the same class at the time of delivery, is filed, listed, or posted by the seller does not come within that category and is valid as a matter of general law. E.g., *Col-Tex Refining Co. v. Coffield & Guthrie, Inc.*, 196 F. 2d 788 (CA 5); *Buggs v. Ford Motor Co.*, 113 F. 2d 618 (CA 7), certiorari denied, 311 U.S. 688; *Ken-Rad Corp. v. R. C. Bohannon, Inc.*, 80 F. 2d 251 (CA 6); see also *Corbin*, Contracts § 98; *Williston*, Sales (Rev. Ed.) § 167. The rates charged by Pacific Northwest are necessarily those filed with the Commission under Section 4 in tariffs of general applicability and hence would not be considered prices estab-

¹⁶ It may be of interest to the Court that the same contentions were presented to the Supreme Court without success in the *Memphis* case. See, e.g., brief for respondents, pp. 33-34; Brief of *City of Hattiesburg, Mississippi, Amicus Curiae, p. 69-70; Brief of State of Wisconsin, Amicus Curiae, pp. 14-19.

lished entirely at the will of the seller even if they were not subject to review by the Commission.¹⁷

And even if the price provision in this case were deemed to be unenforceable as permitting the seller to fix the rates at will, petitioner's conclusion that such an invalidation would bring the case within the rule of *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332, is not sound. For as the cases cited by petitioner show, the entire contract becomes unenforceable if such a price provision is considered invalid unless, as in the *Taller & Cooper* case, *supra*, one of several price conditions can be deemed controlling. But here no fixed price is mentioned in the service agreement, the only price provision referring to the applicable tariff schedule on file with the Commission. If the service agreement here involved were so voided, changes filed would have been

¹⁷ The cases relied upon by petitioner (Pet 11) are not inconsistent with this view. In *Taller & Cooper v. Illuminating Electric Co.*, 172 F. 2d 625 (CA 7), a sales contract provided for the sale of electric irons at a specific price and also included provisions that prices should be as shown in the seller's current price sheet. In concluding that the seller was not justified in raising its price above the amount fixed in the contract, the court held that the specific price fixed in the contract governed. While the court notes that a provision permitting a seller to set the contract entirely at will would invalidate the contract, the principal basis for decision was that the contract price was absolutely fixed, a fact distinguishing list price cases such as those cited by us. *Washington Chocolate Co. v. Canterbury Candy Makers, Inc.*, 18 Wash. 2d 79, 138 P. 2d 195, while relating to a contract to sell candies at "current list price", is not contrary to the general rule sanctioning price provisions referring to filed, listed or posted prices, because there the seller did not in fact maintain a price list of general applicability but set different prices for each customer.

properly accepted by the Commission as *ex parte* filings sanctioned by Section 4(d) in the absence of any contractual relationship. See *United Gas Pipe Line Co. v. Memphis Light Gas and Water Division*, 358 U.S. 103 at 112.

II. The rate filing procedures of Section 4 of the Act are not unconstitutional as applied to changes in rates for sales for resale for industrial use only

Petitioner also contends that it will be denied due process under the Fifth Amendment if Section 4(d) of the Act is construed to permit the unilateral filing of rate increases by Pacific Northwest with respect to sales for resale for industrial use only. Recognizing that the unilateral rate filing scheme it challenges has been approved by the Supreme Court in *Memphis* over objections that Congress could not have intended unilaterally proposed rate increases to go into effect prior to Commission hearings and approval since new rates for sales for industrial resale only cannot be suspended, it seeks to escape the *Memphis* holding on the ground that the constitutional issues it presses were not raised there. It contends here that the procedure sanctioned by the Commission (1) may result in an unconstitutional taking and (2) denies it a hearing as to the reasonableness of the rates, again neglecting to state that its contention in this respect relates only to the period between the filing and the conclusion of the Commission proceeding, and overlooking the fact that the five month's suspension of other increases puts those sellers in a comparable position. Whether or not *Memphis* in fact disposed of these

constitutional questions, these contentions are, we submit, without merit.¹⁸

The contention that the Commission's construction of the Act, as approved by the Supreme Court in *Memphis*, may result in an unconstitutional taking is premised on the assumption that petitioner will have been deprived of the right to recover the unjust and unreasonable portion of its payments, which it would have been able to obtain absent the Act, if the seller's price were found to be not just and reasonable. But absent the Natural Gas Act, we know of no law that a wholesale seller of natural gas could charge only a "just and reasonable" price. Accordingly, the basic premise of petitioner's argument that the Act is arbitrary because it provides no substitute remedy (Pet. 12-17) fails since no prior remedy existed.

Moreover, petitioner's reliance on the declaration in Section 4(a), *infra*, p. 29, of the Natural Gas Act that

¹⁸ The State of Washington filed an amicus curiae brief in *Memphis* in support of the lower court's decision, explaining that its interest resulted from the rate increase filed by Pacific Northwest in 1957 with respect to sales for industrial resale only. Relying on the provision of Section 4(e) of the Act prohibiting the suspension of such industrial resale rates, the State argued that Section 4(d) of the Act should not be interpreted as authorizing a seller to file rate increases thereunder unless the rate increase is specifically agreed to by its customers because, *inter alia*, such a construction avoids the constitutional issue now pressed by the petitioner. The brief for the respondents in *Memphis* also relied heavily on the inequity of permitting the unilateral filing of non-suspendible rate increases (Brief for respondents, pp. 63-71), relying largely on the facts with respect to this proceeding alleged in the petition of intervention of Coos Bay Pulp Corp., et al. (R. 1255).

unreasonable rates are unlawful is misplaced. For this declaration is but part of a regulatory scheme, which cannot be given independent meaning out of the context of the entire Act. As the Supreme Court said in *Montana Dakota Utilities Co. v. Northwestern Public Service Co.*, 341 U.S. 246, at 248, when speaking of the almost identical provisions of the Federal Power Act:

[T]he prescription of the statute is a standard for the Commission to apply and, independently of Commission action, creates no right which courts may enforce.

Petitioner * * * cannot litigate in a judicial forum its general right to a reasonable rate, ignoring the qualification that it shall be made specific only by exercise of the Commission's judgment, in which there is some considerable element of discretion. It can claim no rate as a legal right that is other than the field rate, whether fixed or merely accepted by the Commission, and not even a court can authorize commerce in the commodity on other terms.

And accepting *arguendo* petitioner's assumption that under the *Montana-Dakota* case, and *T.I.M.E., Inc. v. United States*, 359 U.S. 464, a purchaser under a non-suspendible rate schedule would not be able to obtain reparations in a court proceeding even if the Commission finds the filed rates to be unreasonable (Pet. 16), it must also be assumed that a Commission finding that a rate for sales for industrial resale gas only is not reasonable can be given prospective meaning only so that there would be no warrant for finding such rates unlawful under Section 4(a) for the period between

the filing and the termination of a Section 4 rate proceeding.

While the Commission believes that it should be given the power to suspend industrial rates¹⁹ and thereby the power to order these rates to go into effect subject to refund²⁰ so that any finding that a filed rate is unjust and unreasonable could relate back to the time when it went into effect subject to a refund, the provision against the suspension of rates for industrial resale use only involves a statutory effort to strike a balance between the interests of the seller and the purchasers. For while petitioner may suffer a loss on its industrial resales during the pendency of Commission hearings, that fact may be offset in substantial measure by the fact that Pacific Northwest's proposed increases on its other sales were suspended for the five months authorized by Section 4(e), and consequently even should the Commission determine that the increases requested by Pacific Northwest were

¹⁹ The Commission has recommended in each of its annual reports to Congress since 1951, and for some years prior thereto in its justification for appropriations, that the prohibition against suspension of rates for industrial resales be removed from the Act. Annual Repts. of the Federal Power Commission, for 1956-1958, at pp. 144, 152, 154, 170, 181, 18, 24, and 16, respectively.

²⁰ The Commission has consistently taken the view that under Section 4(e) of the Act, its power to permit rates to go into effect subject to a condition that refund be made of those portions of the rates and charges that may later be found unjustified is dependent on its ability to suspend such rates. However, a petition for review is now pending which contends that the Commission has the power to impose refund conditions before permitting non-suspendible industrial resale rates to go into effect. See Petition for Review in *The Gas Service Co., et al. v. F.P.C.*, CADC No. 15401, filed October 9, 1959.

justified in full, petitioner has been relieved from paying the increased rates in other instances during the period of suspension. Cf. *Hope Natural Gas Co. v. F.P.C.*, 196 F. 2d 803 (CA4).

Even if it be assumed that the delays inherent in processing the heavy volume of proposed rate increases have resulted in imposing an undue burden on purchasers of natural gas for industrial resale only, the defect in the Act is one which "must be cured, if at all, by the Legislature." *Public Service Commission v. Iroquois Natural Gas Co.*, 184 App. Div. 285, 287, 171 N.Y. Supp. 379, 381, affirmed 226 N.Y. 580, 123 N.E. 885. See also *Hope Natural Gas Co. v. F.P.C.*, 196 F. 2d 802, 808 (CA4); *Public Service Commission v. Pavilion Natural Gas Co.*, 232 N.Y. 146, 151, 133 N.E. 427, 428; *Armour Packing Co. v. United States*, 209 U.S. 56, 82. For petitioner's basic objection to the statute is that its regulatory scope with respect to industrial resale rates is inadequate. And, indeed, with respect to such rates, the filing procedures only prevent discrimination between similarly situated wholesale purchasers ^{until} ~~as~~ the Commission has an opportunity to pass on the reasonableness of the rates to be charged thereafter. But the determination of whether regulation of such sales should be more extensive must be made by Congress, not the courts. As stated in *Town of North Hempstead v. Public Service Corp.*, 231 N.Y. 447, at 450, 132 N.E. 144, at 145, even if the "method of increasing rates without first obtaining an adjudication as to their reasonableness may appear defective and illogical, * * * no constitutional limitation on legislative power interdicts it * * *."

It should also be noted that while Congress felt that with respect to sales for industrial resale only competition of natural gas with other fuels made the suspension of rate increases unnecessary, petitioner was not required by the Act to purchase its gas for industrial resales under a non-suspendible rate schedule. For while many pipeline sales include gas for industrial resale, the rates for such sales are non-suspendible only if set out completely on a schedule separate from other sales. See *State Corporation Commission of Kansas v. F.P.C.*, 206 F. 2d 690, 698-702 (CA8), certiorari denied, 346 U.S. 922. Indeed, of the eighty largest pipeline companies, only seven make separate (and thus non-suspendible) sales for industrial resale, and such sales averaged only 6.1% of the total dollar volume of the jurisdictional business during the calendar year 1956, and the fiscal years ending in 1956 and 1957.

Here petitioner could have entered into a service agreement for industrial resale gas under Rate Schedule DL-1, relating to Distributing System Service—Large Volume, (R. 9-11), instead of buying under Rate Schedule I-1, relating to interruptible industrial service only (R. 16). But while rate increases under the “DL-1” would have been suspendible, the separate interruptible industrial rate schedule provides a lower rate. In fact, the increased rates under the “I-1” schedule now being paid by petitioner are less than the suspendible “DL-1” rate even if none of the suspended rate increases were to be allowed by the Commission. It is thus apparent that in purchasing under the interruptible schedule petitioner deliberately chose

to risk non-suspendible rate increases, relying on Pacific Northwest's need for new industrial customers and the competition with other fuels to keep the prices at a reasonable level.

The willingness of petitioner to take the risk of increases in non-suspendible rates is also fully explained by the fact that it can pass the increases on to its customers. Thus the State of Washington in its brief (p. 7) in the *Memphis* case said:

* * * While rate increases by the Pacific Northwest Pipeline Company are borne in the first instance by these distributors, their impact is and must necessarily be directly upon the consumers. It could only be otherwise if the distributors were earning in excess of a fair rate of return prior to such increases in their cost of rendering service to their customers.^[21]

²¹ Under the Washington rate filing statute, filed rate changes will go into effect on thirty days notice unless suspended. The maximum suspension period is ten months. See Rev. Code of Washington §§ 80.04.130 and 80.28.060.

CONCLUSION

For these reasons, it is respectfully submitted that the orders of the Commission be affirmed.

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APPENDIX

STATUTES INVOLVED

The pertinent provisions of the Natural Gas Act, 52 Stat. 831, as amended, 15 U.S.C. 717 *et seq.*, provide as follows:

RATES AND CHARGES; SCHEDULES; SUSPENSION OF NEW RATES

SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all

rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulations, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, or State commission, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule

and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect: *Provided*, That the Commission shall not have authority to suspend the rate, charge, classification, or service for the sale of natural gas for resale for industrial use only; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

FIXING RATE AND CHARGES; DETERMINATION OF COST OF
PRODUCTION OR TRANSPORTATION

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

(b) The Commission upon its own motion, or upon the request of any State commission, whenever it can do so without prejudice to the efficient and proper conduct of its affairs, may investigate and determine the cost of the production or transportation of natural gas by a natural-gas company in cases where the Commission has no authority to establish a rate governing the transportation or sale of such natural gas.

REHEARING; COURT REVIEW OF ORDERS

SEC. 19. (a) Any person, State, municipality, or State commission aggrieved by an order issued by the Commission in a proceeding under this act to which such person, State, municipality, or State commission is a party may apply for a rehearing within thirty days after the issuance of such order. The application for rehearing shall set forth specifically the ground or grounds upon which such application is based. Upon such application the Commission shall have power to grant or deny rehearing or to abrogate or modify its order without further hearing. Unless the Commission acts upon the application for rehearing within thirty days after it is filed, such application may be deemed to have been denied. No proceeding to review any order of the Commission shall be brought by any person unless such person shall have made application to the Commission for a rehearing thereon. Until the record in a proceeding shall have been filed in a court of appeals, as provided in subsection (b), the Commission may at any time, upon reasonable notice and in such manner as it shall deem proper, modify or set aside, in whole or in part, any finding or order made or issued by it under the provisions of this Act.

(b) Any party to a proceeding under this act aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the circuit court of appeals of the United States [²²] for any

²² Circuit Court of Appeals of the United States was redesignated as "United States Court of Appeals" by Act of June 25, 1948, 62 Stat. 870.

circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court,

within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be transmitted by the clerk of the court to any member of the Commission and thereupon the Commission shall file with the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in

whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 239 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 346 and 347).

(c) The filing of an application for rehearing under subsection (a) shall not, unless specifically ordered by the Commission, operate as a stay of the Commission's order. The commencement of proceedings under subsection (b) of this section shall not, unless specifically ordered by the court, operate as a stay of the Commission's order.

IN THE
United States Court of Appeals
FOR THE NINTH CIRCUIT

PACIFIC NATURAL GAS CO.,
a corporation,
Petitioner,

vs.

FEDERAL POWER COMMISSION,
Respondent.

No. 16498

REPLY BRIEF OF PETITIONER

Upon Review of Order of Federal Power Commission

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ARGUMENT

I

The contract does not give Pipeline Corporation the right to unilaterally file increased rates for industrial gas under Section 4 of the Act.

It is readily conceded by Petitioner that absent the contract provision "Buyer shall have the right to protest any such new rate schedules and changes before the Federal Power Commission" we would have a typical "Memphis" type agreement. But when Pacific North-

west drew a contract reserving to itself the right to file from time to time under Section 4 of the Act such new schedules and changes in its existing tariff as it might find necessary to, among other things, attract capital, insure expansion and provide adequate natural gas service to its customers, and concluded with the assurance that the Buyer should have the right to protest any such new rate schedules and changes before the Federal Power Commission, this latter provision qualified the reserved right and limited it to those situations where, under the law, the buyer does have an effective right to protest.

Respondent says, on page 16 of its Brief, that

“ . . . the purpose of the right to protest accorded to Petitioner in this case can only be to negate any possible contention by Pacific Northwest that Petitioner had waived its right to protest the justness and reasonableness of changed rates.”

Neither the language of Paragraph 10 of the General Terms and Conditions preceding the last sentence thereof, nor the language of Article III of the Service Agreement could possibly be construed to constitute a waiver by the buyer of its right to protest rate increases. In light of its public service obligation, Petitioner's power to waive such a right may well be doubted, and certainly the Respondent would never approve such a contract provision. However, such considerations are not of moment here. Since the language of the contract, absent that relating to the right of protest, could not be construed as a waiver, the sentence would be wholly unnecessary and without purpose if given the meaning which Respondent ascribes to it.

On page 10 of its Brief, Respondent refers to “. . . petitioner’s reservation . . .” of a “right to protest”. This is an inaccurate description of the provision. Petitioner’s right to protest rate increases is accorded by the Act and the regulations promulgated by the Commission under the authority granted by the Act. As stated by Intervener, it could grant Petitioner no right of protest not provided for by the Act, and we submit it could not deprive Petitioner of any right of protest accorded under the Act. The sentence, when read in light of the preceding language of Paragraph 10, reserving the right to make unilateral changes by filings under Section 4 of the Act, and when read in the context of Section 4 of the Act, becomes completely meaningful when read as limiting the reserved right to make such unilateral changes to those situations where the Buyer has a realistic right to protest.

On page 10 of its Brief Intervener makes the following assertion:

“The true rule, as the Supreme Court held in the *Memphis* case, is that the seller may change the rate and file it under §4(d) unless he has agreed by contract not to do so. 358 U.S. 103, 111, 112-3. What is needed, therefore, to avoid the *Mobile* result is not an agreement to a specific new rate, but merely the absence of any agreement that no new rate will be filed.”

This conception of the *Memphis* holding persists throughout its Brief. We submit that Intervener claims too much for the decision. That decision holds that if there is a contract between the Pipeline and the distributor, its

terms control the right to make changes in rates and according to those terms the Pipeline Company either has or does not have the right to change its rates unilaterally. If there is no contract, the Pipeline Corporation may file its rates *ex parte* and they can be changed *ex parte*. In deciding that case, the court said:

“What has been said disposes of the question whether anything in the Natural Gas Act forbids a seller to change its rates pursuant to §4 procedures simply because its customers have not agreed to the amount of the rate as changed. There remains the question whether United’s service agreements reserved to it the power to make rate change in this manner.”

United Gas Pipe Line Co. v. Memphis Light, Gas & Water Division, 358 U.S. 103; 3 L ed. 2d, 153, 161.

The contract was that of Intervener, prepared by it, filed by it with the Commission, and offered by it to its customers, including Petitioner. The controlling rule of construction under these circumstances is not that referred to by Intervener on page 14 of its Brief, but is the rule that any doubt or ambiguity in the meaning of the contract will be resolved against the Intervener who prepared it, and in favor of the Petitioner. *Wenatchee Production Credit Association v. Pacific Fruit & Produce Co.*, 199 Wash. 651, 92 P.(2d) 883; *Zinn v. Equitable Life Insurance Co. of Iowa*, 6 Wn.(2d) 379, 107 P.(2d) 921; *Willett v. Davis*, 30 Wn.(2d) 622, 193 P.(2d) 321. Intervener argues that such a construction of the contract would nullify the express language reserving to it the right to unilaterally amend its rate schedules and file

such new rates under Section 4 of the Act. This does not follow, because those contract provisions would apply without limitation to rates for all gas other than industrial gas, and as Intervener pointed out on page 2 of its Brief, only a small fraction of the rate increases applied for August 6, 1957 applied to sales of industrial gas to Petitioner here.

On page 20 of its Brief Intervener cites *Nevada Natural Gas Pipe Line Co. v. FPC*, 267 F.(2d) 405 (C.A.5) as controlling precedent. What it does not say is that the rate increases there concerned with did not relate to industrial gas. They were all suspended and permitted to become effective at the end of the suspension period upon the pipe line company giving security to make refunds, if the increased rates were subsequently determined to be unjustified. Necessarily the questions for decision in this case could not have been reached in that case.

That Petitioner for a period of time between the decision of the Court of Appeals in *Memphis Light, Gas & Water Division v. FPC*, 250 F.(2d) 402 (C.A.D.C.) and the reversal of that decision by the Supreme Court of the United States believed itself to be protected on the broad basis of that decision below, only to have that protection cut away as a result of the reversal, cannot mitigate against the position now taken. There is no basis for claim of estoppel, either legal or equitable, nor is any inference properly to be drawn because other interested parties may or may not have seen fit to appeal from the adverse decision of the Respondent to this court.

The Petitioner's argument that the Commission's finding as to the nature of the contract is supported by substantial and uncontradicted evidence is fallacious. There is no evidence beyond the pleadings, and findings can be predicated only upon evidence in the record in the instant proceeding. *Atlantic Refining Co. v. Public Service Commission of New York*, 360 U.S. 378, 3 L ed. 2d 1312.

The contract, when read as a whole, did not grant Intervener the right to change rates for industrial gas unilaterally. Accordingly, the rate fixed by the Service Agreement, namely the rate on file with the Federal Power Commission at the time the Service Agreement was signed, must remain the contract rate until changed by mutual agreement of the parties, or as the result of a proceeding under Section 5 of the Act.

II

CONSTITUTIONALITY

Unless the filing made August 6, 1957, increasing industrial gas rates, is stricken, then from September 6, 1957 until some uncertain time in the future, Petitioner must pay these increased rates, no matter how unjust, unreasonable or discriminatory and any relief will be only prospective. This violates fundamental concepts of reasonableness and due process. We are not here concerned with the general constitutionality of the Act, but only with the provisions of Section 4 as they relate to industrial gas.

In *Hope Natural Gas Co. v. Federal Power Commission*, 196 F.(2d) 803, 809 (C.A.4) the court, in upholding the five months' permissible suspension period provision of Section 4(e) of the Act, said:

“It is true, of course, that a utility is entitled to rates that are just and reasonable; but this is not to say that rates must fluctuate automatically with every change in economic conditions or that a reasonable time may not be allowed for determining the reasonableness of a proposed increase in rates before it is allowed to go into effect. Any loss sustained by a maintenance of the status quo while such determination is being made is properly considered, not as a violation of constitutional right, but as a necessary incident of rate regulation so long as the period of suspension does not ‘overpass the bounds of reason.’ See *American Telephone & Telegraph Co. v. United States*, 299 U.S. 232, 247, 57 S.Ct. 170, 177, 81 L.ed. 142; *Federal Power Commission v. East Ohio Gas Co.*, 338 U.S. 464, 475, 70 S.Ct. 266, 94 L.ed. 268. It is not contended, nor could it reasonably be, that the five months suspension period allowed by the statute is so unreasonable as to amount to a denial of due process. As pointed out by Senator Elkins with respect to the suspension provision of the Mann-Elkins Act, a limited period of suspension pending an investigation of proposed increases is ‘a reasonable limitation upon the exercise of the property rights of the carrier (utility) in fixing a rate.’ 45 Cong. Record 3472.”

We are not here dealing with a situation of “give and take” necessarily involved in the practicalities of the regulatory process. We are not dealing with a situation where the status quo is being preserved. Petitioner's business consists almost entirely in the purchase from Intervener and resale to its customers of industrial gas. The

amounts of money involved are very substantial. Even more substantial to Petitioner is the threatened loss of a great percentage of its business and the actual realized loss of business because of its industrial customers cutting back to their contract minimums. The period of time which has already elapsed is wholly unreasonable and the additional time which will elapse before Petitioner may obtain relief of any kind compounds that unreasonableness. Intervener will, to the extent that its rates are unreasonable, unjust or discriminatory, receive a "wind-fall" and Petitioner will be forever deprived of its property and business without any recourse whatever. Respondent has not pointed to any public purpose to be served by such a statutory scheme, and we submit there can be none.

Intervener argues that failure of Congress to regulate all phases of commerce within an area cannot be a denial of due process. This misconceives the present situation. Our complaint is that Congress gave Intervener too much protection and power without sufficient complementary powers in the F.P.C. to protect the public interest.

The licensing provisions of the Act create or confirm new or existing monopolies or quasi-monopolies. In the case of Intervener, its monopoly in the State of Washington is presently complete. The scope of the Act is comprehensive, and as Intervener properly points out, primary jurisdiction rests with the Commission. Petitioner has no recourse during the long years necessary

to obtain an adjudication by the Federal Power Commission.

If industrial gas were unregulated, we contend that Petitioner would have had a common law right to sue for reparation of unjust charges. Such was the recognized common law right of shippers. In *Arizona Grocery Co. v. Atchison, Topeka & Santa Fe Railway Company*, 284 U.S. 370, 76 L. ed. 348, the Supreme Court of the United States said:

“The exaction of unreasonable rates by a public carrier was forbidden by the common law. *Interstate Commerce Commission v. Baltimore & O. R. Co.* 145 U.S. 263, 275, 36 L.ed. 699, 703, 4 Inters. Com. Rep. 92, 12 S.Ct. 844. The public policy which underlay this rule could, however, be vindicated only in an action brought by him who paid the excessive charge to recover damages thus sustained. Rates, fares, and charges were fixed by the carrier, which took its chances that in an action by the shipper these might be adjudged unreasonable and reparation be awarded.”

We do not find any case holding this rule applicable or inapplicable to customers of a gas pipe line company which has dedicated its property to public use. However, we perceive no basis in principle for any distinction. And whatever may be thought as to the right of reparation at common law, there can be no denial that, absent primary jurisdiction in the Commission, the courts would have been open to an action for injunctive relief against continued unjust, unreasonable or discriminatory rates.

Intervener argues, as we understand it, that in any event, absent the Act, Petitioner should be required to pay the increased rates under its contract. This argument again misconceives the situation. If the Section 4 filing of increased industrial gas rates is rejected, then the rate fixed by the tariff originally filed continues under the terms of the contract until effectually superseded. This could only be done by a rate specifically agreed to and filed under Section 4 or a rate promulgated under Section 5. However, the only question here is whether the filing should have been rejected.

Respondent argues that Petitioner did not have to purchase industrial gas, but could have served its customers with gas purchased under other rates schedules where the Commission has the power to suspend and at the end of the suspension period to permit rates to become effective upon filing of security for refund. Of course, Petitioner did not have to go in the gas business at all. More than ninety-eight per cent of its business involves delivery of gas to customers for industrial use. It has contracted with its customers to furnish to them such gas. The choice which Respondent would offer is, in realistic fact, non-existent.

We submit that the order of the Respondent denying the motion to reject the filing of the Intervener's increased rates for industrial gas should be reversed upon both of the grounds presented on the appeal.

Respectfully submitted,

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No.

16509 ✓

IN THE

United States Court of Appeals For the Ninth Circuit

Kurtis Kay Kusters,

Appellant,

vs.

United States of America

Appellee.

**Appeal from the District Court for the
District of Alaska, Fourth Division**

APPELLANT'S BRIEF

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FILED

MAY - 8 1959

PAUL P. O'BRIEN, CLERK

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No.

IN THE

**United States Court of Appeals
For the Ninth Circuit**

Kurtis Kay Kosters,

Appellant,

vs.

United States of America

Appellee.

APPELLANT'S BRIEF

**Appeal from the District Court for the
District of Alaska, Fourth Division**

STATEMENT OF FACTS

This is an Appeal from a decision and judgment of the Court below, entered January 23, 1959, revoking the suspension of a judgment sentencing the Appellant September 25, 1958, upon a plea of guilty of a charge of forgery. (T. R. p. 5)

An application was made by the United States Attorney upon a petition on the 6th day of January, 1959, which in substance alleged that subsequent to the imposition of a suspended sentence on the Appellant, the said Appellant on the 13th day of November, 1958, was held to answer to a complaint laid before the United States Commissioner, charging the Appellant with the forging of a bill of sale

issued out of a mercantile establishment in Fairbanks and also that a complaint was laid before such Commissioner on November 7, 1958, charging the Appellant with forging and passing a check in the sum of \$18.00. (T. R. 5)

No final disposition has been made of these cases other than that said Appellant was committed to await action of the Grand Jury.

I

THE SUMMARY DISPOSITION OF THE PETITION TO REVOKE THE SUSPENSION DID NOT ACCORD THE APPELLANT A FULL AND COMPLETE HEARING SUCH AS IS CONTEMPLATED BY THE ACT.

The Court below has failed to specifically point out whether in its decision it was guided by the statute providing for revocation of suspended sentences under the Federal Act, or under the Territorial statute.

While counsel conceded that it was not entirely necessary for the Court, in acting upon a revocation of a probationary or suspended sentence, to have a complete adjudication of the offense committed furnishing the basis for such revocation, the authorities, however, hold that the Court must make a full and complete inquiry into the act committed in accordance with the statutes provided. The speculation on the part of the Court below, whether such proceedings was instituted under the Territorial or Federal Act, did not accord Appellant a fair hearing.

The summary disposition of this type of an application violated the rights of the Appellant. (See U. S. vs. Cappleman, 61 Fed Sup 1007 and cases therein cited)

II

THE COURT LACKED JURISDICTION TO ENTERTAIN ANY PHASE OF THE PROCEEDINGS.

The jurisdictional authority of the Court has been challenged by counsel following numerous challenges by other counsel in cases heard before the Alaska Courts since the enactment and the implementation of the Statehood Act. (T. R. p. 7)

In order to save the time of this Court and to expedite this specific proceeding, Appellant will rest on all of the questions raised on the jurisdiction of the Courts in Alaska since the enactment of the Statehood bill.

The Court will undoubtedly take judicial notice of the ascendency of Statehood and the ceasing of the Territorial status of the Government since the President's Proclamation.

Counsel respectfully submits, however, that whether the Court below acted by virtue of the authority of the Territorial statute and construing same as a Court sitting as a Territorial Court, or acted pursuant to the Federal Rules applicable in Alaska, and thus exercised its judicial powers under the Federal statutes, that in either event the Court lacked the jurisdictional functions to entertain the proceedings.

The saving clause in the Statehood Act was not adequate to transform the Court known as a Legislative Court to that of a Constitutional Court and the attempt on the part of the framers of the Alaska Constitution to continue all proceedings unaffected by virtue of Statehood, was inadequate to establish and ordain a court or to vest or deposit power in the existing court. (See Benner et al vs. Porter 50 US p 119; McAllister vs. U. S. 141 US p 174; O'Donoghue vs. U. S. 289 US 516)

CONCLUSION

The question before the Court having been disposed of in a plenary way, without according the Appellant a Hearing contemplated by the statute, and the Court lacking jurisdiction to entertain the proceedings, merits a reversal.

Dated at Fairbanks, Alaska,
April 10, 1959.

Respectfully submitted,

Warren Wm. Taylor

Fred D. Crane

By Warren Wm. Taylor

Attorneys for Appellant

By: Warren Wm. Taylor

Warren Wm. Taylor, Of Counsel

No. 16505 ✓

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

MILTON BIEBER and DONALD PAUL MYERS,
Appellants,
vs.

UNITED STATES OF AMERICA,
Appellee.

APPELLEE'S BRIEF.

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No. 16505

IN THE

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FOR THE NINTH CIRCUIT

MILTON BIEBER and DONALD PAUL MYERS,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLEE'S BRIEF.

I.

JURISDICTION.

The appellants were indicted with six co-defendants in a nine-count indictment on April 30, 1958. A jury trial of appellants only commenced on September 9, 1958, resulting in a conviction of appellants on Counts One and Two of the indictment on September 18, 1958.

The appellants filed individual notices of appeal from the judgment on both counts on October 24, 1958.

The District Court had jurisdiction under the provisions of 18 U. S. C. Sections 371, 471, 472 and 473, and 18 U. S. C. Section 3231. This court has jurisdiction of the appeal under the provisions of 28 U. S. C. Sections 1291, 1294.

II.

STATUTES INVOLVED.

The indictment charges violations of Title 18, Sections 371, 471, 472, 473, United States Code, which statutes are quoted below:

Title 18, U. S. C., Section 371:

“If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than \$10,000 or imprisoned not more than five years, or both.

“If, however, the offense, the commission of which is the object of the conspiracy, is a misdemeanor only, the punishment for such conspiracy shall not exceed the maximum punishment provided for such misdemeanor.”

Title 18, U. S. C., Section 471:

“Whoever, with intent to defraud, falsely makes, forges, counterfeits, or alters any obligation or other security of the United States, shall be fined not more than \$5000 or imprisoned not more than 15 years, or both.”

Title 18, U. S. C., Section 472:

“Whoever, with intent to defraud, passes, utters, publishes, or sells, or attempts to pass, utter, publish, or sell, or with like intent brings into the United States or keeps in possession or conceals any falsely made, forged, counterfeited, or altered obligation or other security of the United States, shall be fined not more than \$5000 or imprisoned not more than 15 years, or both.”

Title 18, U. S. C., Section 473:

“Whoever buys, sells, exchanges, transfers, receives, or delivers any false, forged, counterfeited, or altered obligation or other security of the United States, with the intent that the same shall be passed, published, or used as true and genuine, shall be fined not more than \$5000 or imprisoned not more than 10 years, or both.”

III.

STATEMENT OF PROCEDURAL POINTS.

On April 30, 1958, the Federal Grand Jury in and for the Southern District of California, returned a nine-count Indictment charging appellants, together with Daniel Migdol, James A. Matlock and four others, with counterfeiting government obligations, uttering counterfeit government obligations, transferring counterfeit government obligations and a conspiracy to do the same. The appellants were included in Counts One and Two of the Indictment only.

Count One charged all of the defendants with agreeing, confederating and conspiring to counterfeit obligations of the United States in violation of 18, U. S. C., Section 371, to sell and transfer counterfeit obligations of the United States in violation of 18, U. S. C., Section 473, and to utter counterfeit obligations of the United States in violation of 18, U. S. C., Section 472.

Count Two charged that the appellants and Daniel Migdol falsely made, forged and counterfeited 2,600 \$20.00 Federal Reserve notes and 2,600 \$10.00 Federal Reserve notes.

The appellants were arraigned, and after the appointment of a psychiatrist to examine Donald Paul Myers,

after submission of the psychiatrist's report, and after the appellants had entered their plea of not guilty, the appellants were tried by a jury in the United States District Court of the Southern District of California, Central Division. The jury, on September 18, 1958, found each of the appellants guilty as charged. The other six defendants had previously pleaded guilty.

On October 14, 1958, the appellants were sentenced to two years' imprisonment on Count One and to five years' imprisonment on Count Two of the Indictment, said sentences to be served concurrently.

On October 24, 1958, appellants Bieber and Myers filed individual notices of appeal from the judgment on both Counts [CT. pp. 88 and 94].* Affidavits in support of motion to prosecute appeal in *forma pauperis* were filed by appellants Bieber and Myers on December 3, 1958 [CT. pp. 90-93] and December 8, 1958 [CT. pp. 96-99] respectively. The affidavits are substantially identical and allege: 1) the insufficiency of the evidence to prove appellants had engaged in the manufacture of counterfeit money; 2) the prosecution improperly allowed a written ex parte statement (*sic*) into evidence over the objection of appellant and although eventually stricken, it had been read and referred to in presence of jury and this was the only proof of the charge in Count Two; 3) improper argument of Assistant United States Attorney in referring to this statement and to the prior inconsistent statement of the particular witness; 4) failure of the court to admonish the jury to disregard the improper remarks of the Assistant United States Attorney; 5) admission into evidence of telephone conversations with-

*"TR." refers to the Transcript of Record and "CT." refers to Clerk's Transcript.

out proper foundation; 6) admission into evidence of property of appellants taken without a search warrant and not incident to a lawful arrest; and 7) a general objection on many points to the inadequacy of the charge to the jury.

In appellants' brief, at page 3, it is stated that the appeal is taken only as to Count Two, and the appellants have alleged four specifications of error.

The first specification of error (App. Br. p. 22) appears to be in two parts: First, the failure of the District Court to grant a hearing on the Government's allegation of surprise, and second, the asserted prejudicial error of exposing the jury to "exceptionally damaging unsworn evidence." Although not stated specifically in the specification of error, it is assumed appellants are referring to both oral and written extra-judicial statements of the witness, Daniel Migdol.

The remaining three specifications of error are the refusal by the trial judge to give three jury instructions. The objection to two of the instructions was not made until the jury had retired [TR. pp. 968 and 969], and the objection to the proposed Government's instructions is now made for the first time on appeal.

(Since the extra-judicial statements, both oral and written, were referred to a number of times throughout the trial, the following chronological statement of the procedural points of the case is designed to cover all such references, as well as those occasions on which the alleged misconduct of the Assistant United States Attorney was raised.)

In his opening statement, on September 10, 1958, the Assistant United States Attorney referred to an agreement between Milton Bieber and Danny Migdol to coun-

terfeit money [TR. p. 103] as well as a warning system used by the appellants who he stated were present during the printing operation. [TR. p. 104.]

The first witness called to the stand by the Government was Daniel Migdol, a co-defendant who had pleaded guilty to Counts One and Two. [TR. p. 110.] Migdol stated that he had a conversation with appellant Bieber in reference to the production of counterfeit notes. [TR. p. 112.] Migdol initially denied that there were any warning arrangements. [TR. p. 120.] At that point the Assistant United States Attorney requested permission to ask leading questions on the basis that the witness was hostile. The Court granted permission and the defense counsel objected on the ground that it appeared the Government was going to attempt to impeach its own witness. [TR. p. 121.] The objection was overruled.

The prosecution questioned the witness as to oral statements of the previous day made in Los Angeles in the United States Attorney's office to the Assistant United States Attorney. (For purposes of clarification these statements will be referred to as the "Los Angeles Oral Statements" as distinguished from the "Chicago Written Statement" which shall be referred to hereinafter.) The defense counsel requested a running objection to the particular line of questioning, referring to the "Los Angeles Oral Statement." [TR. p. 122.] The Assistant United States Attorney then commenced to ask leading questions referring to the "Los Angeles Oral Statements" in regard to an agreement to counterfeit money between the witness and Milton Bieber. [TR. p. 122.] Defense counsel objected on the basis that the prosecution was getting to the jury as an "ex parte statement" what the prosecution could not get in by direct evidence. [TR. p. 123.] The defense counsel requested a hearing to deter-

mine whether the Assistant United States Attorney was actually and genuinely surprised. The court denied the request. [TR. p. 124.]

In answering the questions asked as to the "Los Angeles Oral Statements" the witness referred for the first time to the "Chicago Written Statement," stating that the Assistant United States Attorney had questioned him the previous day regarding the latter statement. [TR. p. 125.] The prosecutor directed the witness' attention back to the "Los Angeles Oral Statements."

The witness then denied that he had stated that Milton Bieber had entered an agreement with him to counterfeit money. [TR. p. 125.] The prosecutor asked him if he had not discussed a warning system in the "Los Angeles Oral Statement." [TR. p. 131.] The witness then admitted that he had a warning system set up. [TR. p. 132.] The prosecution, once again referring to the "Los Angeles Oral Statement" asked the witness if he had not told him (the prosecutor) that the appellants were present in the front of the shop while he was in the back room printing. [TR. p. 132.] The witness admitted he had stated that the appellants were there when he started printing but not when he finished. [TR. p. 135.] Previously, the witness had testified that the appellants were not present when he printed the money on the night of March 26. [TR. p. 130.] At this point the prosecuting attorney discontinued reference to the prior inconsistent statements.

The next incident which would seem to have some bearing on this problem occurred immediately after the morning recess in the presence of the jury. Defense counsel stated that *he had heard* that the prosecuting attorney had grabbed a witness in the presence of several mem-

bers of the jury and said, "What are you trying to do to me?" He requested the Court to inquire as to the truth of this and stated he would request a mistrial if it had happened. The Assistant United States Attorney categorically denied that such had happened and the court denied the motion for mistrial. [TR. pp. 157, 158.]

Later, during the course of further direct examination of Migdol, the prosecuting attorney inquired about the written statement made in Chicago by this witness to the United States Secret Service men. The defense counsel objected on the basis that it was another attempt by the Government to impeach its own witness. The court overruled the objection. [TR. p. 175.]

The prosecution asked the witness if he had told them the whole truth. [TR. p. 177.] The witness replied by referring to parts of the "Chicago Written Statement," and denied that he had made a portion of it. [TR. p. 177.] At this point the "Chicago Written Statement" was marked for identification as Government's Exhibit 1. [TR. p. 177.] The prosecuting attorney then asserted that he was attempting to impeach his own witness because he was hostile. [TR. p. 178.]

The witness examined the exhibit and stated he had made it in Chicago and identified his signature. [TR. p. 179.] The defense counsel objected to this procedure and asked to have a voir dire examination to determine if the Government was genuinely surprised. The objection was overruled. [TR. p. 181.]

The prosecuting attorney asked the witness to read the third paragraph which the witness did. [TR. p. 182.] Defense counsel, after personally examining it, stated there was nothing in that portion of the "Chicago Written Statement" that contradicted the testimony of the

witness. [TR. p. 183.] The witness read the paragraph to the jury. When the witness had finished the paragraph, the court ruled that the particular paragraph was not impeaching in that the information contained therein was previously brought out in direct testimony. [TR. p. 188.]

In the direct examination of Charles E. Peyton, Special Agent, United States Secret Service, the prosecuting attorney asked the witness if he had taken a statement from Daniel Migdol in Chicago on April 19, 1958. The witness stated he had and identified Government's Exhibit 1 for identification as the statement taken. [TR. p. 560.] The prosecuting attorney offered Exhibit 1 into evidence. [TR. p. 562.] Upon objection of defense counsel, the court stated it would reserve ruling on the admissibility until defense counsel had opportunity to cross-examine the witness. [TR. p. 562.] The defense counsel again asked for a preliminary hearing to determine the issue of surprise out of the presence of the jury. [TR. p. 562.]

The court granted the request and allowed the jury to retire for the weekend. [TR. p. 564.] The court told defense counsel that he might ask any questions he wished of the witness. [TR. p. 565.] Defense counsel declined on the basis that this wasn't the proper witness. The court inquired as to what witness the defense counsel wished to call. [TR. p. 565.] Defense counsel stated that he didn't wish to cross-examine the particular witness on the stand and he then proceeded to argue at length in regard to the proper procedure for establishing surprise and for the laying of a foundation for impeachment. [TR. pp. 565-570.]

At the conclusion of the defense counsel's argument, the court received the exhibit into evidence. This was still

outside the presence of the jury and the court recessed until the following Tuesday morning at 10:00 a.m. [TR. p. 565.]

On Tuesday, September 16, with the jury present, the trial resumed, and Charles E. Peyton, the witness took the stand. After a short examination of the witness, the prosecution, without any further reference to Government Exhibit 1 whatsoever, concluded and rested its case. [TR. p. 579.] Thereupon, defense counsel requested permission to make motions without the presence of the jury. The court invited him to make these motions at side bar and, accordingly, defense counsel made motions for judgment of acquittal. These motions were denied. [TR. p. 579.] At this time defense counsel, still at side bar, made a motion to strike Exhibit 1 as improper and irrelevant evidence. [TR. p. 580.] The Government offered to withdraw the exhibit and mark it for identification only and the court allowed this procedure to be followed. [TR. p. 581.] In argument, the prosecuting attorney characterized the witness, Daniel Migdol, as a “verbal garbage can.” [TR. p. 870.] Defense counsel objected, and the court stated that argument of counsel was not evidence and the prosecuting attorney continued with his argument. [TR. p. 871.] In answering a question, the defense counsel had raised in his argument as to why the prosecution did not call Bill Smith, a co-defendant who had pleaded guilty, the prosecuting attorney in closing argument cited the instance of Daniel Midgol, who had changed his testimony completely. [TR. p. 942.] Defense counsel did not like this explanation and objected and asked for a mistrial, asserting that the prosecution was now trying to impeach his witness again. The motion for mistrial was denied. [TR. p. 942.]

The court refused several of the defense counsel's requested instructions, including Number 8 (Inference from Possession of Counterfeit Money), and Number 11 (Testimony of Accomplices). [CT. pp. 69, 73 and 74.] The court instructed the jury to disregard the statements and arguments of counsel and not to consider them as evidence. [TR. p. 951.] The court also instructed the jury on the weight to be given to the testimony of an accomplice. [TR. p. 961.] After the jury had retired, defense counsel took exception to the court's refusal to give his instructions but did not specify any grounds. [TR. pp. 968-969.] A verdict of guilty was entered against both appellants on Counts One and Two on Thursday, September 18. [TR. pp. 973 and 974.]

The following day, September 19, defense counsel made an oral motion for a new trial and a hearing on this motion was set for October 14 at 9:30 a.m. [TR. pp. 981 and 982.] On October 14, 1958, the defense counsel waived his motion for new trial as to Bieber, and immediately thereafter the defense counsel withdrew the motion for new trial for the appellant Myers. [TR. pp. 1000, 1001.] The appellants were each sentenced to two-year terms on the first count and five-year terms on the second, the sentences to run concurrently. [TR. pp. 1006-1010.]

IV.

STATEMENT OF FACTS.

Beginning in about January of 1958 appellant Milton Bieber was a partner with one Daniel Migdol in operating a TV repair business located at 12133 Washington Boulevard, Los Angeles, California. [TR. p. 111.] About the middle of March, 1958, financial troubles occurred and Daniel Migdol discussed with Milton Bieber the fact

that he (Daniel Migdol) could counterfeit money. [TR. p. 112.] Subsequent to this conversation, printing equipment was procured by Daniel Migdol and Milton Bieber (appellant) including a printing machine which was leased by both men jointly. [TR. pp. 217, 218.] A camera for photo-lithography was procured by Daniel Migdol and Milton Bieber, as well as a printing press. [TR. p. 115.]

On March 26, 1958, the plates were made [TR. pp. 120 and 130] and the counterfeit money was actually printed that evening by Migdol. About \$78,000 worth of counterfeit money was printed in ten and twenty dollar bills. [TR. p. 120.] At the commencement of the printing of the counterfeit money appellants Bieber and Myers were both present in the front room of the TV repair shop. The money was printed in an adjoining room. [TR. p. 135.] In this adjoining room a warning system had been previously set up by Daniel Migdol. [TR. p. 132.]

A few days later Daniel Migdol asked appellant Bieber if he knew someone in the San Francisco area who he, Migdol, could do business with. [TR. p. 139.] Bieber telephoned to James Matlock in San Francisco and asked Matlock to fly down to Los Angeles to get into a deal. [TR. p. 387.] That evening appellants and Daniel Migdol met James Matlock at the Los Angeles Airport. [TR. p. 143.] At this meeting appellant Bieber explained to James Matlock that the deal involved "queer money." [TR. p. 397.] Daniel Migdol bought tickets for the entire group and they flew back to San Francisco. Daniel Migdol had taken a valise containing \$60,000 and a cardboard box containing a paper cutter and \$15,000 to the airport at Los Angeles. [TR. p. 142.]

When they arrived at the International Airport at San Francisco, appellant Bieber decided to return immediately to Los Angeles and he did so. [TR. p. 146.] Daniel Migdol took the valise with the \$60,000 and boarded an airline terminal bus in San Francisco. [TR. p. 146.] James Matlock took the cardboard box and held it during this bus trip. [TR. pp. 148-149.]

Daniel Migdol and the appellant Myers and James Matlock rode together on this bus to the Don Hotel in San Francisco where they obtained three individual rooms on the same floor [TR. p. 149] under fictitious names. [TR. p. 403.]

James Matlock went to appellant Myers' room and, in the presence of Daniel Migdol, asked to see the money. [TR. p. 404.] He was requested to close the blinds, which he did. When he turned around Daniel Migdol handed Matlock two \$20.00 bills which he took from an open brown suitcase filled with money which was lying on the bed. [TR. p. 405.] James Matlock asked to see a smaller bill and was given a \$10.00 bill by Daniel Migdol. James Matlock commented on its lighter color and the appellant Myers took a bill and demonstrated how to age it by rubbing it up and straightening it on a desk or sharp surface. Appellant Myers also explained that perspiration would darken it a little bit. [TR. pp. 405, 406.] The treatment had helped darken the color but Matlock preferred the 20's and was given seven or eight more 20's by Daniel Migdol. [TR. p. 406.]

The three men left the hotel room and went to a bar. However, only James Matlock and appellant Myers entered the bar with the purpose of cashing some money. Appellant Myers paid for a drink with a \$20.00 bill and commented, after the bartender had left, "Wasn't that

easy." [TR. p. 408.] They then left the bar and separated, and James Matlock went alone and passed some more bills. [TR. pp. 408, 409.]

At 8 a.m. both the attaché case and the appellant Myers were gone from the hotel [TR. pp. 152, 153]; but the sealed box with the \$15,000 was in James Matlock's room. Daniel Migdol flew back to Los Angeles the next evening. [TR. p. 154.] A few days later, at the International Airport checking box, he opened a locker with a key given to him by the appellant Bieber, and took out a suitcase which contained the money previously printed and which he had last seen in the suitcase in San Francisco.

In March of 1958 Luis Del Gado met appellant Bieber in a bar [TR. p. 325] and three or four days later [TR. 327] went to Bieber's TV shop where Bieber showed him counterfeit money on printed sheets eight by ten containing about four bills of 10's and 20's. [TR. pp. 330-332.] Bieber then cut one sheet with a razor blade and gave the bills to Del Gado, [TR. p. 332.]

Since Daniel Migdol and appellant Bieber had a number of insufficient checks outstanding and had previous criminal records they feared any investigation by the District Attorney's office. [TR. p. 160.] They decided to take a trip out of the State [TR. p. 161], therefore, Daniel Migdol and the appellants Bieber and Myers, who had rejoined the group, left Los Angeles at 8 p.m., about the middle of April. [TR. pp. 160, 161.] The counterfeit money was put in a cardboard box and sealed with fibre tape by Daniel Migdol. [TR. p. 162.] The three men drove to West Memphis, Tennessee. [TR. p. 162.] During the trip, at approximately 2:30 to 3 a.m., at a point between Gallup, New Mexico, and Amarillo, Texas, on

Highway 66, Daniel Migdol disposed of the sealing plates and negatives used in counterfeiting that he had taken in the car. [TR. p. 164.] The men then arrived in West Memphis, Tennessee, and after some time returned to Missouri. [TR. p. 166.] Daniel Migdol left Bieber and Myers in a hotel in St. Louis, and he flew from the St. Louis Airport to Midway Field, Chicago. [TR. p. 170.] Here, he leased a 1957 Cadillac, drove to Chicago, and checked in at the Bismarck Hotel at 2 a.m. [TR. pp. 170-171.]

About 5:30 p.m. that evening, Migdol, pursuant to a telephone call, met Bieber and Myers at O'Hara (*sic*) Field, Illinois. He drove them back to Chicago, ate with them and then allowed them to take the car, which he had previously leased, to go sightseeing. [TR. pp. 171-172.]

During the early morning hours of April 19, 1958, appellants Bieber and Myers were involved in an automobile accident at Wilmette, Illinois, while riding in a 1957 Cadillac coupe. [TR. pp. 546 and 521.] In response to an accident call, Officer Harold Graf of the Wilmette Police Department proceeded to the scene of the accident with the police ambulance. Upon his arrival with a fellow officer, Officer Graf removed the driver of the car Bieber, from behind the wheel and placed him in an ambulance. They then took the driver to the Evanston Hospital, Evanston, Illinois. Appellant Myers was found at the scene of the accident by officers of the Evanston Police Department and also taken to the Evanston Hospital. Both appellants sustained injuries from this accident. [TR. pp. 525-528.] At the Evanston Hospital, Officer Graf assisted the doctor in removing Bieber's clothing and in a search for identification they found an argyle sock in a sport coat pocket which the appellant had

been wearing. [TR. pp. 529, 530.] The sock contained counterfeit \$20.00 Federal Reserve notes [TR. p. 530] [Ex. 6] which was folded with two genuine one-dollar bills in appellant Myers' jacket. [TR. pp. 530, 531.]

Daniel Migdol was apprehended later that day and taken to the United States Secret Service office in Chicago, Illinois, on April 19, 1958, where he signed a written statement. [TR. p. 560.]

V.

SUMMARY OF ARGUMENT.

1. Prior Inconsistent Statements
 - A. Appellee's Position
 - B. Determination of Hostility
 - C. Refreshing Recollection of Hostile Witnesses
 - D. Attempted Impeachment
2. Jury Instructions
 - A. Non-compliance with Rule 30
 - B. Government's Proposed Supplemental A Instruction
 - C. Appellant's Proposed Instruction 11
 - D. Appellant's Proposed Instruction 8
3. Remark of Trial Judge
4. Sufficiency of the Evidence

ARGUMENT.

1. Prior Inconsistent Statements.

A. Appellee's Position.

The defense counsel during the course of the trial and the appellants in their brief have failed to adequately distinguish between the use of the "Los Angeles Oral Statements" and the "Chicago Written Statement." As a result they have assumed that the only use to which the "Los Angeles Oral Statements" was put, was to impeach the testimony of Daniel Migdol. This assumption is quite apparent from the statements of the defense counsel. [TR. p. 121.] The Assistant United States Attorney had asked the court for permission to propound leading questions to a hostile witness:

"Mr. Atkins: Your Honor I am going to beg the Court's indulgence in my asking this witness leading questions. He has turned hostile. His testimony is absolutely opposite to what he has told me previously.

The Court: You may go ahead and ask him leading questions." [TR. p. 120.]

Defense counsel objected, and, in furtherance of his objection, stated to the court:

"Mr. Warner: Well, if your Honor please, counsel for the Government had indicated a protocol that he is going to follow now and I think it is highly objectionable, and the damage will have been done merely by asking the question. I think that there should be a preliminary hearing outside of the hearing of the jury to determine whether the Government is going to be allowed to impeach its own witness." [TR. p. 121.]

The Assistant United States Attorney at that point had not made any indication that he was going to impeach his own witness. It has long been established that the party calling a witness may be allowed, at the discretion of the trial court, to interrogate him by the use of leading questions, especially where the party is a hostile witness. The purpose of these leading questions is to ascertain the truth from an otherwise unwilling witness who may be trying to suppress the facts. The prosecutor referred to the "Los Angeles Oral Statements" to refresh the recollection of a hostile witness in order to induce him to tell the truth. The third paragraph of the "Chicago Written Statement" was later used by the prosecutor in an unsuccessful attempt to impeach the same witness, Daniel Migdol. It was unsuccessful because it did not contradict the previous direct testimony of the witness.

B. Determination of Hostility.

Appellants have made much to do about the fact that the court never held a hearing to determine surprise. It is common practice and good law for the trial court to rely on the assertion of counsel that he has been surprised or that the witness is hostile. In this particular instance the court was aided by the fact that the witness was a codefendant who had previously pleaded guilty, and the court was well aware of the discrepancy between the prosecuting attorney's opening statement and the witness' initial testimony.

Appellants have cited *Gendelman v. United States*, 191 F. 2d 993 (9 Cir. 1951), as authority for the proposition that a hearing should be held to determine surprise. The case does not state that; it states, at page 996, that:

" . . . a witness may, with permission of the court, be examined as to specific prior contradictory

statements if the trial court finds that his testimony at the trial comes as a genuine surprise to the party calling him as a witness. *United States v. Maggio*, 3 Cir., 1942, 126 F. 2d 155, 159, cert. denied, 316 U. S. 686, 62 S. Ct. 1275, 86 L. Ed. 1758.”

United States v. Maggio, 126 F. 2d 155 (3 Cir. 1942), cited and partially read by the defense counsel at the time of trial [TR. pp. 194-197], should have clarified for the defense counsel that he was not entitled to a hearing. However, though he quoted a portion of the case to the trial judge, he did not quote the following excerpts at page 159 which state:

“In the Federal Courts the rule was early modified so as to permit questioning for the purpose of refreshing the recollection of the witness. *Hickory v. United States*, 151 U. S. 303, 309, 14 S. Ct. 334, 38 L. Ed. 170.”

* * * * *

“The trial court was entitled to accept the statement of the United States attorney that he was surprised by the testimony of the witness and thereupon exercise its discretion in permitting the examination as to the prior self-contradictory statements. (Citation.)”

“Certainly the trial judge is not required in every such case to interrupt the trial in order to investigate whether the allegation of surprise is justified by the facts.”

In *Wheeler v. United States*, 211 F. 2d 19 (D. C. C. A. 1953), cert. den. June 7, 1954, 74 S. Ct. 876, the court discussed the use of a prior inconsistent statement for

purpose of impeachment of a ten-year old girl who had been criminally attacked by the defendant. In that instance the court also had an opportunity to discuss the manner in which the trial judge might determine “surprise.”

After the prosecution had called the ten-year old girl, she contradicted the earlier statement she had given to the police, and the prosecution made a claim of surprise which the court upheld and exercised its discretion thereunder to permit cross-examination and impeachment. The court stated, at page 25:

“Maintaining that the prosecution was not ‘taken by surprise,’ appellant argues that, under the statute, the court was precluded from permitting cross-examination and impeachment of the child. The statute merely codifies the established rules concerning the impeachment of one’s own witness and allows ample latitude for application of a broad concept of ‘surprise’ by requiring only that the ‘court shall be satisfied’ that ‘surprise’ exists. In terms of our review, this means that the trial court’s ruling on ‘surprise’ may not be disturbed unless it plainly appears that the ruling is without any rational basis.”

C. Refreshing Recollection of Hostile Witness.

Specifically there were three points of divergence. The prosecuting attorney in his opening statement said that the defendant Milton Bieber and the witness Daniel Migdol had agreed to counterfeit money in the middle of March; second, that there was a warning system in the front room which was used by the appellants during the course of the printing, and third, that both appellants were present while the witness Daniel Migdol printed money in a back room of a TV repair shop.

On the first point the witness Migdol admitted that the appellant Bieber and he had talked on counterfeiting money. He testified:

“Q. Now, along in March of 1958, did you conceive of an idea with Milton Bieber of printing counterfeit money?

Mr. Warner: I certainly object to a leading question like that. That is the most—

Mr. Atkins: Well, your Honor, we have to get to the point some time.

The Court: I will overrule the objection. You may answer.

The Witness: What was your question?

Q. By Mr. Atkins: Whether you arrived at a scheme with Milton Bieber for counterfeiting Federal Reserve notes. A. It was just conversation at that particular time, it was strictly—

Q. What were the circumstances? A. Well, the circumstances, we ourselves, the television plant was in pretty bad shape, and I knew of a way of making—of raising the money and I just talked the thing over to see what we could do.

Q. When was this? A. The middle of March, about the second week in March.

Q. And where did this conversation take place? A. In the television shop.

Q. About what time of day was it? A. Oh, evenings.

Q. And what was the gist of that conversation? A. Well, the gist of the conversation was that I was with the knowledge of producing it, of produc-

ing counterfeit notes satisfactorily enough so we could actually raise some cash.

Q. By the production of counterfeit bills? A. Yes." [TR. pp. 111, 112.]

On the second point, the witness initially denied that there was any warning system. Through the use of leading questions and referring to the "Los Angeles Oral Statements" and in that manner refreshing the witness' recollection, the prosecuting attorney brought out that there was, in fact, a warning system, and he also brought out the fact that the appellants were present at the time of commencement of the printing of the money.

The original denial that there was a warning system is recorded as follows:

"Q. Did you have any warning arrangements for the printing? A. No. The market, the adjoining building of our television store is a Laundromat, a 24-hour Laundromat, and our shop is known to be open until around 9:00 o'clock at night, so if a person was in there, it wasn't out of the ordinary that we are in there; I was back there, I was in a locked room, and it is in the middle of the building, and so with the hi fi going they can't—it was next door at the same time—they couldn't actually hear what was going on.

Mr. Atkins: Your Honor, I am going to beg the court's indulgence in my asking this witness leading questions. He has turned hostile. His testimony is absolutely opposite to what he has told me previously.

The Court: You may go ahead and ask him leading questions." [TR. p. 120.]

His qualification came later in the following manner:

“Mr. Atkins: I am talking about your statement to me yesterday afternoon in my office. A. All right. The statement I told you yesterday, I may have told you ten words that ought to be in fifteen pages. I was told that I was lying, that it was not the right story, to give you the right story, and I cannot give you any other story. Now, I did have a system set up there. If I did have somebody sitting out there, it was a simple system, but at the time I printed the notes there was nobody in that television shop. The people were gone. The hi fi was going, but there was nobody in the front of the shop.” [TR. p. 132.]

On the third point, Migdol initially denied appellants were present at the time of the printing, as follows:

“Q. By Mr. Atkins: Had you made any arrangements for a warning system while you were printing this counterfeit money on March 26, 1958? A. At the time I made the negatives and made the plates, I was alone.

Q. I am talking about the printing of the money. A. I am talking about the printing. The money of the plates and the printing of the money was done on the night of the 26th and I was alone.

Q. Wasn't Milton Bieber around there? A. They were not present.

Q. Who was 'they'? A. Donald came down, it must have been a couple of days later with Milton, they came down to the plant. I don't think they were there. They were gone when I came back. The hi fi circuits, they were going.

Q. Was the warning system set up? A. No, sir. There was nobody to put it on. There was no reason for it.” [TR. p. 130.]

By the use of leading questions and refreshing the witness’ recollection and by referring to the “Los Angeles Oral Statement,” the prosecuting attorney was able to have the witness qualify that statement and admit the appellants were present when he started to print the money, in the following manner.

“Q. By Mr. Atkins: In other words, you did not make that statement to me? A. I did not make it as a direct statement.

Q. Of your own free will, without you being threatened? A. It wasn’t made as a direct statement. It may have been written down as far as you were concerned, but I told you that they were out there, when I entered the room in the back, they were out there with the hi fi, when I originally started printing, and when I did come out, the people were gone.” [TR. p. 135.]

The word “they” on line 12 of page 135 refers back to line 6 on page 134, “With Donald Myers and Milton Bieber present in front of the television shop.”

The courts have long recognized the use of leading questions in conjunction with a prior inconsistent statement to induce a reluctant witness to tell the truth as distinguished from the use of such statements to impeach the witness. This procedure was spelled out in *Hickory v. United States*, 151 U. S. 303 (1893), where the court stated at page 309:

“When a party is taken by surprise by the evidence of his witness, the latter may be interrogated

as to inconsistent statements previously made by him for the purpose of refreshing his recollection and inducing him to correct his testimony; and the party so surprised may also show the facts to be otherwise than as stated, although this incidentally tends to discredit the witness. As to witnesses of the other party, inconsistent statements, after the proper foundation laid by cross-examination, may be shown; *Railway Company v. Artery*, 137 U. S. 507; but proof of the contradictory statements of one's own witness, voluntarily called and not a party, inasmuch as it would not amount to substantive evidence and could have no effect but to impair the credit of the witness, was generally not admissible at common law. Best Ev. § 645; Wharton Ev. § 549; *Melhuish v. Collier*, 15 Q. B. 878.

“By statute in England and in many of the States, it has been provided that a party may, in case the witness shall in the opinion of the judge prove adverse, by leave of the judge, show that he has made at other times statements inconsistent with his present testimony, and this is allowed for the purpose of counteracting actual hostile testimony with which the party has been surprised. *Adams v. Wheeler*, 97 Mass. 67; *Greenough v. Eccles*, 5 C.B. (N.S.) 786; *Rice v. Howard*, 16 Q.B.D. 681.”

The appellants have relied on *Block v. United States*, 88 F. 2d 618 (2 Cir. 1937), where Judge Learned Hand criticized the prosecutor who continually referred to a written statement made by the witness and which the witness consistently denied. However, the court impliedly ap-

proved the general procedure followed by the prosecutor in that case if it is kept within proper bounds.

“ . . . One of the prosecution's witnesses was Daniel Block, a brother of the defendant, Max Block. Before the trial he had been subpoenaed to appear before the grand jury or the prosecutor, to whom he made a statement which was taken down by a stenographer and typed. This incriminated both Max Block and Levy; the witness said in substance that together with Griffin they were the leaders in the enterprise, and had often discussed the still and the general business in his hearing, especially at Block's house where they lived. When called at the trial this witness proved recalcitrant and would not stand by his story. The prosecutor for a while unsuccessfully plied him in the usual way; he would remember nothing of any consequence and what he did was vague and unconvincing; it was plain to anyone who had the *ex parte* examination before him, that he had had a change of heart and meant to protect his brother. The prosecutor thereupon turned the examination into a cross-examination; and this the judge allowed—quite properly, for it was obvious that the witness was suppressing the truth. That also proved unsuccessful; and the prosecutor began to use the earlier statement. First, he asked the witness to read it, and see whether it did not refresh his recollection. It did not. Finding himself thus baffled, the prosecutor then began to read the examination, question and answer, asking him after he had read a passage, whether it was true. The witness, so cornered, tried to excuse himself by saying that he had been frightened; that he had answered what he thought would

best please; and that all the incriminating answers were fabrications of the moment. This was continued until the whole of the statement had been read to the jury, though all that was of any moment he explicitly disclaimed. All this time the defendants continually protested and were uniformly overruled. Upon his charge the judge told the jury that they might use any part of the statement which the witness had admitted; but none that he had not.

“The position of a prosecutor, faced with a pre-jured witness whom he had called with good warrant to support him friendly, is trying, and the courts have not dealt hardly with him. In *Di Carlo v. United States*, 6 F. 2d 364, we said that he should be given the greatest latitude in examination and allowed to use the earlier statement, even at the risk that the jury might take it as testimony; indeed, we went so far as to say that it was possible that it might in fact become testimony; for a witness upon the stand may so behave that his conduct is more of an affirmation of an earlier statement than his halting words are a denial; . . .”

The *Block* case was reversed because the witness consistently denied the truth of all his prior statements, which distinguished *Block* from the case at hand where affirmative testimony was adduced through cross-examination, as we have shown earlier in this argument.

The manner of examination and the latitude to be allowed rests in the sound discretion of the trial judge which is the basic test of propriety. *Poliafico v. United States*, 237 F. 2d 97 (6 Cir. 1956), at page 108 states:

“Appellants claim that it was error on the part of the court to permit the government attorney to

cross examine two government witnesses on their contradictory grand jury testimony, after they had turned hostile, and the government had been taken by surprise. The prior testimony, which was read to the witnesses, was for the purpose of refreshing their memory, and did, in fact, refresh their memory in a number of instances. The trial court clearly and thoroughly explained to the jury that such cross examination was permitted only to refresh the witnesses' recollection, and that the questions and answers read to them were not evidence to be considered by the jury in the case.

“ ‘When a party is taken by surprise by the evidence of his witness, the latter may be interrogated as to inconsistent statements previously made by him for the purpose of refreshing his recollection and inducing him to correct his testimony; and the party so surprised may also show the facts to be otherwise than as stated, although this incidentally tends to discredit the witness.’ *Hickory v. United States*, 151 U. S. 303, 309, 14 S. Ct. 334, 336, 38 L. Ed. 170.

“In *Di Carlo v. United States*, 2 Cir., 6 F. 2d 364, 368, the court said:

“ ‘This latitude to be allowed in the examination of a witness, who has been called and proves recalcitrant, is wholly within the discretion of the trial judge. Nothing is more unfair than to confine a party under such circumstances to neutral questions. Not only may the questions extend to cross-examination, but, if necessary to bring out the truth, it is entirely proper to inquire of such a witness whether he has not made contradictory statements at other

times. He is present before the jury, and they may gather the truth from his whole conduct and bearing, even if it be in respect of contradictory answers he may have made at other times. . . . The possibility that the jury may accept as the truth the earlier statements in preference to those made upon the stand is indeed real, but we find no difficulty in it. If, from all that the jury see of the witness, they conclude that what he says now is not the truth, but what he said before, they are none the less deciding from what they see and hear of that person and in court. There is no mythical necessity that the case must be decided only in accordance with the truth of words uttered under oath in court.'

"In *United States v. Socony-Vacuum Oil Co.*, 310 U. S. 150, 233, 60 S. Ct. 811, 849, 84 L. Ed. 1129, the Supreme Court said, in a similar case:

" 'As in case of leading questions, * * * such use of grand jury testimony for the purpose of refreshing the recollection of a witness rests in the sound discretion of the trial judge. See *Di Carlo v. United States*, [2 Cir.] 6 F. 2d 364, 367-368; *Boselman v. United States*, [2 Cir.] 239 F. 82, 85; *Felder v. United States*, [2 Cir.] 9 F. 2d 872. He sees the witness, can appraise his hostility, recalcitrance, and evasiveness or his need for some refreshing material, and can determine whether or not under all the circumstances the use of grand jury minutes is necessary or appropriate for refreshing his recollection.' "

Similar language is also found in the case of *Feutralle, et al. v. United States* (5 Cir. 1954), 209 F. 2d 159, at page 162:

“Considerable discretion is allowed the trial court in the manner in which the examination of witnesses shall be conducted. That court, by its presence, can gauge the circumstances much better than they can be presented by a cold record. The court could well conclude that the witnesses had become hostile and sought to evade. The recital of the prior statements afforded ample grounds for government counsel’s pleas of surprise in each instance. Even then, however, counsel did not precisely seek to impeach the witness, but rather sought to use the statements as a means of refreshing the recollection of the witness and then, by leading questions, comprising as to Rowe the entire recital of the statement and as to Kelly by the separate contents of the statement, to secure the correction of the previously evasive, and in some respects conflicting, responses in the testimony of the witnesses upon the trial. When the testimony was completed, in each instance the truth of the matter was admitted to be as contained in the statement. Neither of the statements included any hearsay recitations. The recitals of each related only to matters which were admissible against the defendants upon the present trial. We do not have here, therefore, a case where the consistent and final denial by the witness of the recitals of the statement render such recitals mere hearsay, entirely inadmissible as substantive evidence, and proper for consideration only for impeachment purpose and which, even for this purpose should be admitted to no extent further

than is necessary to undo the harm caused by unexpected testimony. Such improper use of written statements we have uniformly condemned.”

D. Attempted Impeachment.

Later in the interrogation of the witness Daniel Migdol, the prosecutor expressly stated that he was attempting to impeach Migdol by use of a prior statement, the “Chicago Written Statement.” [TR. p. 178.]

The witness was allowed to read the entire “Chicago Written Statement” to himself. The defense counsel was allowed to examine it and attention was particularly directed to paragraph three which deals primarily with an agreement between defendant Bieber and the witness Daniel Migdol. Immediately after the witness had read paragraph three to the jury (the jury was never allowed to see the statement and no other portion was referred to throughout the trial), the court stated:

“The Court: Why don’t you make a motion to strike it out? I told you a few minutes ago I am trying to help you.

Mr. Warner: Yes, sir.

The Court: Yes.

Mr. Warner: Well . . .

Mr. Atkins: I would like to have the witness read that last sentence once with all the words in it.

The Court: The court on its own motion will strike out from your minds what he has just read, on the grounds that it is not impeaching, because he has already told you about that this morning.

The Witness: The last four lines or one sentence? Not the last line . . .

The Court: Isn't that in substance, Mr. Migdol, what you told the jury a little while ago? A. Yes, sir, exactly. There isn't a thing in here—the only thing that is here, they got a name of 'Milton' put in there, it says 'Milton and I decided.' Milton and I did not decide. They got the name Milton in here. That is what I was trying to get at.

The Court: I do not feel that that particular part is impeaching, because he has already told the jury that in substance already this morning.

Mr. Atkins: He denied vehemently that they had had an agreement, your Honor.

The Witness: Well, this does not mean that we had an agreement.

Mr. Atkins: And that statement has in it that 'Milton and I decided' that. That is an impeaching statement.

The Court: He explained that a little while ago. He explained that." [TR. pp. 188, 189.]

The prosecutor was attempting to impeach the statement of the witness that there was no agreement between the appellant Bieber and himself. In the "Chicago Written Statement" the witness had previously stated, "Milton and I decided." The witness was now denying this. If this was an inconsistency, then the prosecutor had the right to impeach the witness who had given affirmative evidence of a *lack* of an agreement.

Hickory v. United States, supra;

Poliafico v. United States, supra;

Wheeler v. United States, supra.

The court expressed its opinion that the statements were not inconsistent and after the matter had been put

before the jury he instructed them, in effect, to disregard the "Chicago Written Statement."

The defense counsel, after he had examined the paragraph three of the "Chicago Written Statement," had also insisted that there was no contradiction, as follows:

"Mr. Warner: There is nothing in that particular paragraph pointed out by Mr. Atkins which either contradicts the testimony of this witness or . . ."
[TR. p. 183.]

Since the court ruled exactly in accordance with the position taken by the defense counsel, it is inconceivable that any prejudice resulted from this. If the court's ruling was incorrect in that there was some inconsistency, then certainly the prosecutor was within proper bounds, where he was surprised by a now hostile witness, in attempting to impeach such witness with a previous inconsistent statement on a material point.

2. Jury Instructions.

A. Non-Compliance With Rule 30.

Appellants failed to comply with Rule 30 of the Federal Rules of Criminal Procedure with regard to the granting or denying of the request for instructions in two particulars. First, defense counsel did not take exception to the instructions that were granted nor to those that were refused until after the jury had retired to the jury room to deliberate. The following appears in the record:

"(Whereupon, at the hour of 11:11 A.M. the jury retired to the jury room to deliberate upon its verdicts.)

(The following proceedings were had before the court, without the presence of the jury:)

Mr. Warner: Just for the record, may I take an exception?

The Court: All right, take an exception. Go ahead.

Mr. Warner: We have your blessing, then.

The Court: Go ahead. Go ahead.

Mr. Warner: O. K. In behalf of the defendants Bieber and Myers I take exception to the instructions numbered Government's 3, 6, 7 and 16, and take exception to the Court's refusal to give instructions 1 to 13 inclusive, of the defendants' proposed jury instructions.

The Court: All right. Did you state all exceptions?

Mr. Warner: Yes, sir, I did." [TR. pp. 968, 969.]

From the above quotation it is also apparent that defense counsel did not state the grounds of his belated objection. Appellants cannot for the first time on appeal object to the instructions given to the jury by the trial court. Rule 30 of the Federal Rules of Criminal Procedure is not satisfied by an objection in a general manner. If the trial judge is not given an opportunity to rule on the specific objection, the error complained of need not be considered on appeal. (*United States v. Bender*, 218 F. 2d 869 (7th Cir. 1955).)

This court has passed upon the failure of parties to raise their objection to the instructions prior to the jury retiring. In the case of *Brown v. United States*, (9th Cir. 1955), 222 F. 2d 293 at 298, this court stated:

"Appellant objects to one of the jury instructions given by the court. It is not necessary to discuss the merit of the disputed instruction inasmuch as no

objection to it was made by appellant prior to the time the jury retired.

“Rule 30 of the Federal Rules of Criminal Procedure, Title 18, U. S. C. A., provides in material part:

“* * * no party may assign as error any portion of the charge or admission therefrom unless he objects thereto . . . before the jury retires to consider its verdict * * *.’”

“And this court recently stated in *Enriquez v. United States*, 9th Cir. 1951, 188 F. 2d 313, 316:

“‘We may say that Rule 30 is not designed as a mere trap for the unwary. Painstaking compliance with its requirements, although not an easy matter for the lawyer, is of the very essence of the orderly administration of criminal justice.’”

In 1955 in *Herzog v. United States*, 226 F. 2d 561, (9th Cir. 1955) a division of this court considered the relationship of Rule 30, Federal Rules of Criminal Procedure, and Rule 52, Federal Rules of Criminal Procedure. The court was attempting to clarify the apparent inconsistency between *Bloch v. United States*, 221 F. 2d 786 (9th Cir. 1955), rehearing denied 223 F. 2d 297 (9th Cir.), and the case of *Brown v. United States*, *supra*, which was decided three days after the *Bloch* case and in the opinion of the court had overruled *sub silentio* the *Bloch* case. The court found that Rule 30 and Rule 52 did not nullify each other and stated at page 569:

“Rule 30 is clear and unambiguous and its application is not dependent upon the personal whims of the court. It provides that no portion of the charge

to the jury or omission therefrom may be assigned as error unless objection is made before the jury retires. This rule which has the force of law leaves no area in which it may be disregarded.”

In explaining the purpose of Rule 52 the court stated at page 570:

“The manifest intent of the rule [52] is to permit courts *sua sponte* to notice error which the parties through neglect or inadvertence failed to call to the court’s attention, but *it does not authorize the consideration of matters which another rule specifically states shall not be assigned as error.*”

This court *en banc* granted a rehearing in the *Herzog* case, *Herzog v. United States*, 235 F. 2d 664 (9th Cir. 1956), cert. den. 77 S. Ct. 54. The rehearing was limited to the one issue as to whether the power of the court under Rule 52 (b) of the Rules of Criminal Procedure, 18 U. S. C. A., is limited or circumscribed by the provision of Rule 30. This court then made a distinction that Rule 30 referred to the action of a party, whereas Rule 52 (b) referred to a grant of authority to the court, in the following language at pages 666 and 667:

“Criminal Rule 30 by its terms precludes *a party* from assigning as error the giving of an instruction to which he has not objected on the trial. Rule 52 (b), appearing under the caption ‘General Provisions,’ is not directed to the party, but is a grant of authority to the court itself. These rules are not conflicting. Rather, they complement each other. Rule 52 (b) was doubtless designed to take care of unusual or extraordinary situations where, to prevent a miscarriage of justice or to preserve the in-

tegrity of judicial proceedings, the courts are broadly empowered to notice error of their own motion. The rule is in the nature of an anchor to windward. It is a species of safety provision a precise scope of which was left undefined. Its application to any given situation must in the final analysis be left to the good sense and experience of the judges.

* * * * *

“This court has not gone overboard in its application of Rule 52 (b) to situations such as here presented, and it does not propose to do so now. In the great bulk of the cases in which counsel have sought to have us consider claims of error in instructions not objected at the trial we have declined to do so. More than once we have stressed the salutary nature of the Rule 30 and the vitally important part it plays in the administration of justice . . . But, in common with the generality of the circuits, we recognize that the Rule does not debar us from noticing of our own motion error in instructions thought to have resulted in a miscarriage of justice.

* * * * *

“In determining whether the giving or the failure to give an instruction warrants a reversal, the courts are not to consider the instruction in isolation. They are obliged to examine the charge as a whole in light of the factual situation disclosed by the record. Such is the course followed even in the normal criminal case, where the accused has preserved his right of review by timely and appropriate objection on the trial.”

Procedurally, therefore, the appellants have not properly raised their objections to jury instructions. The Govern-

ment's proposed Supplemental "A" Instruction was never adopted by defense counsel at the trial and the court's refusal to give it is first raised in appellant's brief. Specifications of error 3 and 4 (Appellant's Brief page 22) deal with the refusal of the trial court to grant appellants' proposed instructions 11 and 8, respectively. The objection to the failure to give these instructions came immediately after the jury had retired and defense counsel failed to state the ground of his exception or point out any error that was prejudicial to the defendant. Consequently, he has failed to comply with Rule 30 and if the specifications of errors are to be considered by the court at all it can only be under Rule 52 (b).

For the reasons stated hereinafter it is the position of the Government that there was no prejudicial error in failure to grant these instructions and accordingly the specifications of error should be disregarded.

B. Government's Proposed Supplemental "A" Instruction.

There was no error in the court's refusal to give Government's proposed Supplemental "A" Instruction which refers to the "Chicago Written Statement" [CT. p. 70]. At the time this instruction was offered and refused by the court, the defense counsel made no objection to the court's ruling [TR. pp. 948, 949].

On the basis of what transpired during the course of the trial, it is quite apparent that the court's refusal to give the Government's proposed Supplemental "A" Instruction was quite proper. The "Chicago Written Statement" was never before the jury. It had been introduced into evidence at a hearing out of the presence of the jury, was not referred to when the jury returned, and then at side bar, when the Government rested, was with-

drawn from evidence [TR. pp. 565, 579, 580]. The only portion of the “Chicago Written Statement” which the jury was aware of was paragraph three which the witness read at the trial judge’s instruction [TR. p. 185]. It is interesting to note that neither the court nor the defense counsel nor the witness himself considered this paragraph to be contradictory to his previous testimony and for that reason the court on its own motion had the paragraph which was read stricken as evidence.

Paragraph “three” which the witness read [TR. pp. 186, 187] appeared to be the same as the witness’ previous testimony which was material and relevant and not objectionable on the grounds that it contained hearsay. Accordingly, the court’s refusal to grant the instruction was quite proper and consistent with the previous court ruling in respect to which both the witness and the defense counsel had agreed that the statement was not impeaching.

C. Appellant’s Proposed Instruction 11.

What appellants have raised in their third specification of error is precisely the point that this court decided against their contention in the case of *Cowell v. United States* (9th Cir. 1958), 259 F. 2d 660 and the issue before the court in that case was whether or not the “better rule” referred to in the case of *Holmgren v. United States* (1910), 217 U. S. 509 at 523 and 524, must be given in instructions on the corroborative circumstances that must surround the testimony of an accomplice. In appellant’s brief at page 40, this comment appears referring to the *Cowell* case and also *Mims v. United States* (9th Cir. 1958), 254 F. 2d 654:

“In each, this court paid lip service to the ‘better practice’ outlined in the *Holmgren* case (corroborat-

ing evidence for the testimony of an accomplice) but then found reasons for concluding that, in the circumstances presented, each of the juries had been adequately instructed.”

This is not a fair statement of what the court stated in Cowell. In Cowell the court merely delineated the issue which it was facing and the court concluded that it is not necessary to follow what was the so-called “better rule” of the *Holmgren* case. The Supreme Court case of *Caminetti v. United States* (1917), 242 U. S. 470, at 495, similarly held that it was not reversible error to refuse to caution the jury as to the weight to be given to the testimony of an accomplice. Hence, the ruling of the District Court was proper.

D. Appellants’ Proposed Instruction 8.

In their fourth specification the appellants object to the refusal to grant appellants’ proposed instruction No. 8 which accurately states the law and is supported by the cases which appellants have cited. In neither of the cases that were cited however was the issue a refusal of the court to grant an instruction as to the inference to be drawn from mere possession of counterfeit money. In both cases the issue was sufficiency of the evidence and the crime charged was the passing knowingly and wilfully of counterfeit money. (*Marson v. United States* (6th Cir. 1953), 203 F. 2d 904 also contained a conspiracy charge.) In the instant case appellants were charged in count 2 with manufacturing and counterfeiting.

The only question at this point is did the court adequately instruct on the two charges on which the appellants were tried—to wit; Count One and Count Two.

Although appellants have stated in their brief that they are limiting this appeal to Count Two (Appellant's Brief, page 3) it is submitted that a review of the court's instructions both as to Count One and Count Two clearly indicate that the court adequately covered the essential elements of the crimes. The instructions given in regard to Count One are set forth in the Clerk's Transcript pages 49-53; 55-57 [TR. pp. 953-958]. The instructions given in regard to Count Two are set forth in Clerk's Transcript at page 60 [TR. pp. 962, 963].

3. Remark of Trial Judge.

To bolster their position with regard to appellants' proposed instruction No. 11, appellants on page 41 of their brief attempt to bring before this Court an allegation of misconduct on the part of the trial judge because of a remark made, recorded at page 894 of the transcript of record.

"Mr. Warner: . . . Now, in view of the limited time, I am not going into a further delineation of Matlock. I think I could mention several other things which would indicate that he occupied the position of Mr. A in this little story about A and B and that he comes within this group, who is either amenable to suggestion, has guile and cunning or a combination of both so that he could get off the hook himself. Remember, he had pleaded guilty to this charge a long time ago. He hasn't been sentenced yet, five months later he hasn't been sentenced yet. Do you see a reason for his testimony? Five months. There is something unusual about that. What better way could he get off the hook? What better way than by having Myers on the string?

The Court: Well, I will tell you right now, he is not going to get off the hook. I am going to sentence him.

Mr. Warner: He is going to be sentenced?

The Court: They have pleaded guilty and they will be sentenced, and they are not going to get off the hook, either one of them. I thought you would like to know.

Mr. Warner: Now, we have the testimony of Del Gado."

The position of appellee on this point is twofold. First appellants have failed to follow the proper procedure in raising this point. Second, the judge's comment was quite proper under the circumstances.

In *United States v. Wernecke* (7th Cir. 1943), 138 F. 2d 561, the Court ruled on the comment of the trial judge to the jury which defense counsel raised for the first time on appeal. The remark of the trial judge came as he was excusing the jury. The Court had this to say at page 564:

"Furthermore, the defendant made no objection to the Court's statement at the time it was made and took no steps to correct any supposedly prejudicial conduct so as to give the Court a chance to correct any mistake it might have made. The objection cannot be taken here for the first time."

The obvious purpose for this rule is to provide for the orderly administration of justice and to allow the trial judge, if he has inadvertently or mistakenly made an improper remark to the jury, to correct the error at that point rather than to have a continuation of a case by ap-

peal and retrial resulting in an undue extension of time and effort which might have been very simply avoided.

In this instance, the defense counsel made no objection to the Court's remark at the time of trial. It is now raised here as a collateral matter, supposedly to bolster appellants' position with regard to the failure to grant appellants' proposed instruction No. 11 [CT. p. 74].

It is not germane to that instruction; either the one the Court granted was correct or it was not correct. The alleged misconduct of the trial judge in a comment to the jury certainly has no direct relationship to that instruction. It is an attempt to bring before this Court something that should have properly been objected to at the time of trial; if in fact there was a valid objection.

The trial judge is the person charged with the responsibility of protecting the dignity and decorum of the court and he alone is in the best position to judge when prosecuting attorneys or defense counsel are overstepping their bounds. It is submitted that a glance at the portion of the transcript quoted *supra* on this particular point indicates that the defense counsel invited the comment of the Court when he stated that this particular witness had not been sentenced for five months and that there was something unusual about it and what better way could he get off the hook. The only fair conclusion to that and to the rejoinder of the Court is that defense counsel had gone too far and had invited the rejoinder of the Court which, under the circumstances, certainly was not prejudicial to anyone and was only designed to correct any possible misinterpretation by the jury and also to prevent an affront to the Court.

4. Sufficiency of the Evidence.

Appellants have quoted at length from their own testimony (Appellants' Brief, pages 18, 19 and 20) as though the jury was bound by their testimony and ought to disbelieve that of the Government witnesses. Although appellants have not specified as an error, sufficiency of the evidence, it is quite apparent from the phraseology of appellants' brief they are indirectly doing so. The phraseology referred to is as follows:

"... the tenuousness of the case supported by the available direct testimony against appellants, ... with the result that little if any of the evidence considered by the jury was approached by it with a proper mental set.

"... while a defendant may be convicted solely on the unsupported direct testimony of a co-conspirator, it is impossible to determine in this case whether such was the result since there was also before the jury throughout a substantial portion of the trial hearsay of a far more imposing and detailed nature . . .

"In view of the limited probative value of the direct testimony against appellants, . . .

"Excepting for government witness Migdol's hearsay statement, there was only the weakest of evidence against either of the appellants. . . . Other than these two quanta of more or less suspect testimony, there is absolutely no direct evidence . . . The testimony of Leland Griffith, . . . regarding the finding of aluminum plates . . . was totally unilluminating . . .

"In view of the paucity of incriminating direct testimony, it is submitted . . ." (Appellants Brief, pages 23, 24 and 25.)

Reference is made to appellee's statement of facts for clarification of the evidence presented. Suffice to say that this Court is not concerned with weighing the evidence or passing on the credibility of witnesses. The convictions should be sustained if there was substantial evidence, taking the view most favorable to the Government, to support it.

United States v. Glasser (1942), 315 U. S. 60, 80;
Arena v. United States (9th Cir. 1955), 226 F. 2d
227, 229, cert. denied 350 U. S. 954 (1956).

Conclusions.

The Court properly granted the prosecuting attorney permission to ask leading questions of a hostile witness.

The prosecuting attorney properly made use of prior inconsistent oral statements for the purpose of refreshing the recollection of the hostile witness and inducing him to tell the truth.

The Court did not err in refusing the instructions indicated in appellants' specifications of error.

The evidence was sufficient to sustain the conviction.

Respectfully submitted,

LAUGHLIN E. WATERS,
United States Attorney,
ROBERT JOHN JENSEN,
Assistant U. S. Attorney,
Chief, Criminal Division,
TIMOTHY M. THORNTON,
Assistant U. S. Attorney,
Attorneys for Appellee.

No. 16515 ✓

United States
Court of Appeals
for the Ninth Circuit

A. J. BUMB, Trustee in Bankruptcy of the Es-
tate of Ampco Products of California, Inc.,
Bankrupt,

Appellant,

vs.

L. E. McINTYRE and M. H. McINTYRE, Doing
Business as L. E. McIntyre & Co.,

Appellees.

Transcript of Record

Appeal from the United States District Court for the
Southern District of California
Central Division

FILED

OCT 12 1959

PAUL P. O'BRIEN, CLERK

No. 16515

United States
Court of Appeals
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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NAMES AND ADDRESSES OF ATTORNEYS

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Los Angeles 17, California.

In the District Court of the United States, Southern District of California, Central Division

In Bankruptcy—No. 82,754—T

In the Matter of

AMPSCO PRODUCTS OF CALIFORNIA, INC.,

Bankrupt.

PETITION FOR ORDER TO SHOW CAUSE

To the Honorable Benno M. Brink, Referee in Bankruptcy:

Petitioners L. E. McIntyre and M. H. McIntyre, Co-Partners doing business under the fictitious firm name and style of L. E. McIntyre & Company, respectfully show as follows:

I.

Prior to the filing of the Involuntary Petition for Bankruptcy in this proceeding, petitioners filed an action in the Superior Court of the State of California, in and for the County of Los Angeles, against Ampsco Products of California, Inc., and other named defendants, entitled "L. E. McIntyre and M. H. McIntyre, Co-Partners doing business under the fictitious firm name and style of L. E. McIntyre & Company, Plaintiffs, vs. Ampsco Products of California, Inc., a California Corporation, et al., Defendants," No. 688141. Said action seeks recovery upon a Promissory Note secured by a Mortgage of Chattels. Attached hereto, marked Ex-

hibit A, and by reference made a part hereof, is a full, true, and correct copy of the said Note and Mortgage of Chattels, which was recorded on June 14, 1956, in Book [2*] 51460, Page 320, Official Records of Los Angeles County, California.

II.

It will be noted that the said Note is executed by Ampsco Products of California, Inc., which is now the Bankrupt herein, and by other parties. Petitioners must maintain the said action in order to preserve their rights as against the said other parties, and a determination of the validity of the Mortgage of Chattels, as between Petitioners and the Trustee in Bankruptcy herein, is essential to a determination of the ultimate rights of petitioners, as against the said other parties.

III.

Petitioners represent that a multiplicity of proceedings would be avoided if a determination of the validity of the Mortgage of Chattels were to be made in the said action by the said Superior Court. The determination of the validity of the Mortgage of Chattels must be made according to California law, and the convenience of all parties, including the Trustee herein, would be served by an adjudication of that forum.

Wherefore, Petitioners pray that this Court issue an Order to Show Cause, directed to A. J. Bumb,

*Page numbering appearing at foot of page of original Certified Transcript of Record.

Trustee herein, requiring him to show cause, at a time to be fixed by the Court, why he should not be required to cause himself to be substituted as a party defendant in place and instead of Ampsco Products of California, Inc., in the said Superior Court action, requiring that the said Trustee appear and defend the said action, and why an Order should not be made herein that the determination of the Superior Court in the said action as to the validity, or non-validity, of the said Mortgage of Chattels shall be binding in these proceedings, and that, if the said Superior Court determines the Mortgage of Chattels to be valid, a preferred lien, to the extent of the said Mortgage of Chattels, shall bind the proceeds of the sale of any property which the said Superior Court shall determine to have been subject to the said [3] Mortgage of Chattels.

Dated this 15th day of January, 1958.

FORSTER & GEMMILL,

By /s/ JOHN G. GEMMILL,

Attorneys for Petitioners.

[Endorsed]: Filed Jan. 16, 1958, Referee. [4]

[Title of District Court and Cause.]

ORDER TO SHOW CAUSE

The Court having read the Petition for Order to Show Cause filed herein on behalf of L. E. McIn-

tyre and M. H. McIntyre, d/b/a L. E. McIntyre & Company,

It Is Hereby Ordered that A. J. Bumb, Trustee in Bankruptcy herein, is hereby ordered to appear before this Court on January 30, 1958, at the hour of 10:00 o'clock a.m., then and there to show cause, if any there be, why this Court should not make the following Order:

That A. J. Bumb as Trustee in Bankruptcy herein, be required to cause himself to be substituted as a party defendant in place and instead of Ampsco Products of California, Inc., in the action pending in the Superior Court in and for the County of Los Angeles, State of California, entitled "L. E. McIntyre and M. H. McIntyre, Co-Partners doing business under the Fictitious Firm Name and Style of L. E. McIntyre & Company, Plaintiffs, vs. Ampsco Products of California, Inc., a California corporation, [6] et al., Defendants," No. 688141, and requiring that the said Trustee appear and defend the said action on behalf of the Bankruptcy Estate;

That the determination of the Superior Court in the said action, as to the validity, or non-validity, of the said Mortgage of Chattels, shall be binding in these proceedings;

That if the said Superior Court determines the Mortgage of Chattels to be valid, a preferred lien, to the extent of the said Mortgage of Chattels, shall bind the proceeds of any sale of any property which

the said Superior Court shall determine to have been subject to the said Mortgage of Chattels.

It Is Further Ordered that this Order to Show Cause, together with a copy of the Petition upon which it is based, be served upon the said Trustee, or his attorney, by mail, not later than five (5) days before the date of the hearing hereon.

Dated this 16th day of January, 1958.

/s/ BENNO M. BRINK,
Referee in Bankruptcy.

[Endorsed]: Filed Jan. 16, 1958, Referee. [7]

[Title of District Court and Cause.]

ANSWER TO PETITION AND COUNTER-
CLAIM OF TRUSTEE FOR ORDER DE-
CLARING CHATTEL MORTGAGE NULL
AND VOID

ANSWER

Comes now A. J. Bumb and by way of answer to the Petition of L. E. McIntyre and M. H. McIntyre, Co-Partners d/b/a L. E. McIntyre & Company, filed January 16th, 1958, admits, denies and alleges as follows:

I.

Your respondent alleges that the assets of the bankrupt are all in the actual or constructive possession of your Trustee.

II.

That your Trustee cannot, from a reading of the alleged chattel mortgage, determine with any particularity whatsoever what assets of the bankrupt corporation are allegedly subject to the chattel mortgage. Your Trustee further alleges, however, based upon information and belief, that all of the physical assets of the bankrupt corporation were sold prior to the commencement of these bankruptcy proceedings, by the Assignee for the benefit of creditors of said corporation and that the net proceeds of said sale [8] are in the process of being transmitted to your Trustee, without any adverse claim being asserted thereto by said Assignee for the benefit of creditors.

III.

That your Trustee denies the validity of the subject chattel mortgage, and in that connection, therefore, admits that a determination of the validity of said chattel mortgage is proper and essential.

IV.

Your Trustee does not consent to be substituted as a party defendant in the place and stead of Ampsco Products of California, Inc., in the said Superior Court action. Your Trustee alleges that it would be contrary to the interest of this estate, involving unnecessary litigation and unnecessary expense to require your Trustee to appear in and defend said Superior Court action.

V.

Your Trustee alleges that this Court, the Court in which the within bankruptcy proceedings are pending, has the exclusive jurisdiction to control the administration of this bankrupt estate and is the proper Court to try and determine the validity of all claims and liens relating to the assets of the bankrupt.

Counterclaim

By way of counterclaim respondent A. J. Bumb respectfully alleges:

I.

That he is the duly elected, qualified and acting Trustee in bankruptcy of the above-named bankrupt estate.

II.

That among the assets belonging to the estate of said bankrupt are cash funds resulting from the sale, held prior to the commencement of these bankruptcy proceedings, by Ralph Meyer as [9] Assignee for the benefit of creditors of this bankrupt, of the physical personal property of the bankrupt which had been in the possession of and used by the bankrupt in the operation of its business prior to the execution of said assignment for the benefit of creditors on or about August 19th, 1957.

III.

That the petitioners herein, L. E. McIntyre and M. H. McIntyre, Co-Partners doing business under the fictitious firm name and style of L. E. McIntyre

& Company, claim to have a lien upon assets of the bankrupt estate by virtue of a mortgage of chattels bearing date of May 25th, 1956, a copy of which mortgage of chattels is attached as Exhibit A to the petition herein.

IV.

That said chattel mortgage is, under the laws of the State of California, invalid and of no effect whatsoever for the following reasons:

1. That said mortgagee failed to comply with the requirements of the law as pertaining to publishing notice of intention to execute a chattel mortgage, no such notice having been filed prior to the execution and recordation of such chattel mortgage, and

2. That there was undue and unreasonable delay in the recordation of such chattel mortgage, which delay was detrimental to creditors of the bankrupt, in that the chattel mortgage dated May 25th, 1956, was not filed for recordation until June 14th, 1956, and

3. The attempted description of the property to be subject to said chattel mortgage, as set forth in said mortgage, is legally inadequate as it is not sufficient and definite enough to identify the items of personal property which are subject to such chattel mortgage. [10]

There are creditors of the bankrupt now in existence who were creditors at the time of and prior to the recordation of said chattel mortgage.

Wherefore your Trustee as respondent and counterclaimant prays as follows:

1. That the petition herein be denied.

2. That this Court make and enter its Order declaring the above-described chattel mortgage null and void and that this Court enter a further Order that petitioners L. E. McIntyre and M. H. McIntyre and L. E. McIntyre & Company, a co-partnership, have no interest whatsoever in the assets of this bankrupt estate or the proceeds thereof, except that said petitioners may file a general unsecured claim in this bankruptcy proceeding for the amount claimed by them, this being without prejudice to the rights of the Trustee herein to examine such claim and to object thereto if it appears that objection is proper.

Dated: January 31st, 1958.

/s/ A. J. BUMB,
Trustee.

SHUTAN and FEINERMAN,

By /s/ ROBERT H. SHUTAN,
Attorneys for Trustee.

Duly verified.

[Endorsed:] Filed Feb. 1, 1958, Referee. [11]

[Title of District Court and Cause.]

ANSWER OF L. E. McINTYRE AND
M. H. McINTYRE TO COUNTERCLAIM

Come now L. E. McIntyre and M. H. McIntyre, Co-Partners doing business under the fictitious firm name and style of L. E. McIntyre & Company, and answer the Counterclaim of the Trustee herein, by which said Counterclaim the Trustee requests an Order declaring the Chattel Mortgage null and void, by admitting, denying, and alleging as follows:

I.

Answering Paragraph III of the said Counterclaim, L. E. McIntyre and M. H. McIntyre admit that they claim to have a lien upon the assets of the Bankrupt Estate, and affirmatively allege that they have such a lien by virtue of the Mortgage of Chattels bearing date of May 25, 1956, a copy of which is attached as Exhibit A to the Petition for Order to Show Cause on file herein.

II.

Answering Paragraph IV, L. E. McIntyre and M. H. McIntyre deny generally and specifically each and every allegation therein contained, and affirmatively allege as follows: [13]

(1) A Notice of Intended Mortgage was published and recorded, as required by Section 3440.1 of the Civil Code of the State of California in con-

nection with the execution of the said Mortgage, and the payment of the proceeds to the Bankrupt;

(2) There was no undue or unreasonable delay in the recordation of the said Chattel Mortgage. The said Chattel Mortgage was executed and delivered through an Escrow at Security-First National Bank of Los Angeles, Broadway and Florence Branch, Escrow No. 129-5912, under which publication and recordation, under the provisions of Civil Code Section 3440.1, were had, and the said Chattel Mortgage was recorded pursuant to the said Notice under said Section 3440.1. This is the reason that the Mortgage was dated May 25, 1956, and was recorded June 14, 1956;

(3) The description of the property subject to the Chattel Mortgage, as set forth therein, is a sufficient description under the laws of the State of California;

(4) None of the amounts owing by Ampsco Products of California, Inc., to creditors as of the date of the said Chattel Mortgage, and as of the date of the recording thereof, were owing to creditors of the Bankrupt at the time of the adjudication of bankruptcy herein.

Wherefore, L. E. McIntyre and M. H. McIntyre pray that this Court declare the Chattel Mortgage to be valid, and declare that the said parties have a first and prior lien upon the funds of the Bankrupt Estate resulting from the sale of the property covered by the Chattel Mortgage, to the extent of

the balance due thereon, which said balance is hereby alleged to be \$17,474.02, together with attorneys' fees in the sum of 10% thereof, as provided in the said [14] Chattel Mortgage, or \$1,747.40.

Dated February 12, 1958.

FORSTER & GEMMILL,

By /s/ JOHN G. GEMMILL,

Attorneys for L. E. McIntyre
and M. H. McIntyre.

Affidavit of Service by Mail attached.

[Endorsed]: Filed February 13, 1958. [15]

[Title of District Court and Cause.]

FINDINGS OF FACT AND CONCLUSIONS
OF LAW, AND ORDER, RE CHATTEL
MORTGAGE

The Petition for Order to Show Cause filed herein by L. E. McIntyre and M. H. McIntyre, Co-Partners doing business under the fictitious firm name and style of L. E. McIntyre & Company, the Order to Show cause issued thereon, dated January 16, 1958, the Answer to Petition and Counterclaim of Trustee on file herein, the Answer of L. E. McIntyre and M. H. McIntyre, Co-Partners doing business under the fictitious firm name and style of L. E. McIntyre & Company, to the said Counterclaim, and the Order to Show Cause herein directed to L.

E. McIntyre and M. H. McIntyre, d/b/a L. E. McIntyre & Company, and Harvey Aikins, Mrs. Harvey Aikins, John E. Brodbeck, Mrs. John E. Brodbeck, and Security-First National Bank of Los Angeles, having come on regularly for hearing on March 10, 1958, before Honorable Benno M. Brink, Referee in Bankruptcy, and the Trustee appearing through his attorneys, Messrs. Shutan and Feinerman, by Robert H. Shutan, Esq., and Milton Feinerman, Esq., and L. E. McIntyre and M. H. McIntyre, d/b/a L. E. McIntyre & Company, appearing through their attorneys, Messrs. Forster & Gemmill, by John G. Gemmill, Esq., [17] Harvey Aikins and Mrs. Harvey Aikins appearing through their attorney, Sigfried Levitt, Esq., connected with the office of Bernard D. Flaxman, Esq., Security-First National Bank of Los Angeles appearing through its attorney, G. H. Banta, Esq., and John E. Brodbeck and Mrs. John E. Brodbeck having failed to appear, but proof of service of the said Order to Show Cause having been filed herein, and the Court having received documentary evidence and having heard oral testimony, and certain stipulations of fact having been entered into in open Court and in writing between counsel for the respective parties, and the Court having decided the matter in favor of L. E. McIntyre and M. H. McIntyre, Co-Partners doing business under the fictitious firm name and style of L. E. McIntyre & Company, the Court makes the following

Findings of Fact

1. For a valuable consideration, the Bankrupt, Ampsco Products of California, Inc., and Harvey Aikins, Mrs. Harvey Aikins, John E. Brodbeck and Mrs. John E. Brodbeck executed and delivered to L. E. McIntyre & Company that certain Promissory Note dated May 25, 1956, in the principal amount of \$27,500.00, and, as security therefor, the same parties executed and delivered to L. E. McIntyre & Company that certain Mortgage of Chattels dated May 25, 1956, which said Mortgage of Chattels was acknowledged under date of June 8, 1956, and was recorded on June 14, 1956, in Book 51460, Page 320, Official Records of Los Angeles County, California. Full, true, and correct copies of the said Note and of the said Mortgage of Chattels are attached to the Petition for Order to Show Cause filed herein on behalf of L. E. McIntyre and M. H. McIntyre on January 16, 1958, and the same are hereby incorporated herein by reference.

2. The said Note and Chattel Mortgage were executed and delivered through an escrow at Security-First National Bank of Los Angeles, Broadway and Florence Branch, Escrow No. 129-5912. A Notice of Intended Mortgage with respect to the said Mortgage of Chattels [18] was executed, recorded, and published, as required by California law, through the said escrow.

3. The Notice of Intended Mortgage, which is in evidence herein, states that the same was to be de-

livered, and the consideration was to be paid, at 10:00 o'clock a.m. on June 12, 1956, at the place where the said escrow was held.

4. There was no unreasonable delay in the recordation of said Mortgage of Chattels.

5. Inventories describing in detail the property covered by the Mortgage of Chattels were initialed on behalf of the Mortgagor and Mortgagee, and were deposited in said escrow; but such Inventories were not attached to or made a part of said Mortgage. The said Inventories describe the fixtures, Machinery and tooling equipment owned by the Bankrupt located at 224 East Palmer Avenue, Compton, California.

6. The description of the property contained in the said Mortgage of Chattels, as recorded, is sufficiently definite to enable third parties, aided by inquiries which the instrument itself suggests, to identify the property covered thereby.

7. Pursuant to the written Stipulation on file herein between the Trustee and L. E. McIntyre & Company, through their respective attorneys, the Court finds that the proceeds of sale (by Ralph Meyer, as Assignee for the Benefit of Creditors herein) of the furniture, fixtures and tooling equipment of the Bankrupt located at 224 East Palmer Avenue, Compton, California, was \$28,775.00, and that the unpaid principal balance on the Note secured by said Chattel Mortgage is \$17,474.02. From the evidence, the Court finds that the attorneys' fees

payable under the Note and Chattel Mortgage are \$1,747.40, and that interest will accrue at the rate of 10% per annum on \$17,474.02 from and after July 1, 1958.

From the foregoing Findings of Fact, the Court makes the [19] following

Conclusions of Law

1. This Court has jurisdiction to determine the validity of the said Mortgage of Chattels as against the Creditors, the Bankruptcy Estate, and the Trustee in Bankruptcy herein.

2. The Mortgage of Chattels is valid and enforceable against Creditors, this Estate, and the Trustee in Bankruptcy herein.

3. The property covered by the Mortgage of Chattels, having been sold by Ralph Meyer, as Assignee for the benefit of Creditors herein, and the sale proceeds having been delivered to the Trustee in Bankruptcy herein, the lien created and evidenced by the said Mortgage of Chattels has attached to the funds in the hands of the Trustee herein which represent the proceeds of the sale of the fixtures, machinery and tooling equipment of the Bankrupt located at 224 East Palmer Avenue, Compton, California.

4. L. E. McIntyre and M. H. McIntyre, d/b/a L. E. McIntyre & Company, are entitled to an Order that they be paid from assets, consisting of cash, in the hands of the Trustee, the sum of \$17,474.02 principal, \$1,747.40, attorneys' fees, and

interest at 10% per annum on \$17,474.02 from and after July 1, 1958; provided, however, that the total amount so to be paid for principal, attorneys' fees and interest shall not exceed the proceeds of the sale of the property covered by the Chattel Mortgage less such expenses of sale as this Court may allow.

Having made the foregoing Findings of Fact and Conclusions of Law, the Court now makes the following

Order

It Is Hereby Ordered as follows:

1. The Petition of L. E. McIntyre and M. H. McIntyre, insofar as it requests that the Trustee be ordered to appear in and defend the state court action therein described, is denied. [20]

2. The relief prayed for in the Counterclaim of the Trustee is denied.

3. The Mortgage of Chattels executed by the Bankrupt in favor of L. E. McIntyre & Company, and recorded on June 14, 1956, in Book 51460, Page 320, Official Records of Los Angeles County, California, is valid and enforceable against the Creditors of the Bankrupt, this Bankruptcy Estate, and the Trustee herein, and the lien thereof be, and the same hereby is, transferred to the assets of the Bankruptcy Estate herein, consisting of cash, now in the hands of the Trustee as a first lien thereon.

4. The Trustee shall pay to L. E. McIntyre and M. H. McIntyre, d/b/a L. E. McIntyre & Company,

in payment of the Note secured by the Mortgage of Chattels referred to in the preceding paragraph, the sum of \$17,474.02 principal, \$1,747.40 attorneys' fees, and interest on \$17,474.02 from and after July 1, 1958; provided, however, that the total amount so to be paid for principal, attorneys' fees, and interest shall not exceed the proceeds of the sale of the property covered by the Chattel Mortgage less such expenses of sale as this Court may allow.

Dated this 27th day of May, 1958.

/s/ BENNO M. BRINK,
Referee in Bankruptcy.

Affidavit of Service by Mail attached.

[Endorsed]: Filed May 27, 1958, Referee. [21]

[Title of District Court and Cause.]

PETITION FOR REVIEW OF
REFEREE'S ORDER

To the Honorable Benno M. Brink, Referee in
Bankruptcy:

The petition of A. J. Bumb respectfully represents:

I.

That your petitioner is the duly elected, qualified and acting Trustee in Bankruptcy of the above-named bankrupt estate.

II.

That on the 27th day of May, 1958, an Order was made by the Referee herein, and filed in this Court, a copy whereof is hereto annexed marked Exhibit "A" and made a part hereof.

III.

Your petitioner being aggrieved by the said Order prays for a review thereof and complains that the Court committed error in making the said Order in the particulars as set forth in the following paragraphs.

IV.

The Referee erred in respect to said Order, in that the Referee's Finding of Fact No. 6 is clearly erroneous in that [23] said Finding 6 actually constitutes a conclusion, which conclusion is not supported by the evidence adduced at the hearing on said matter.

V.

The Referee erred in respect to said Order in that the Referee's Findings of Fact fail and omit to include a finding as to which of the items of furniture, fixtures and tooling equipment which were sold by Ralph Meyer, as Assignee for the benefit of creditors, were covered by the subject Chattel Mortgage.

VI.

The Referee erred in respect to said Order in that the Referee's Conclusion of Law No. 2 is clearly erroneous, in concluding that the subject Mortgage

is valid and enforceable against creditors, this estate, and the Trustee in Bankruptcy herein.

VII.

The Referee erred in respect to said Order, in that the Referee's Conclusions of Law Nos. 3 and 4 are clearly erroneous, each being based upon the erroneous conclusion that the subject Chattel Mortgage is valid and enforceable.

Wherefore your petitioner prays that said Order be reviewed by a Judge of this Court and that the Referee promptly prepare and transmit to the Clerk thereof his Certificate thereon, together with a statement of the questions presented and a transcript of the evidence taken at the hearing or a summary thereof and all exhibits therein offered.

Dated: May 28, 1958.

/s/ A. J. BUMB,
Trustee, Petitioner.

SHUTAN & FEINERMAN,
By /s/ ROBERT H. SHUTAN,
Attorneys for Petitioner.

[Endorsed]: Filed May 31, 1958, Referee. [24]
Affidavit of Service by Mail attached.

[Title of District Court and Cause.]

REFEREE'S CERTIFICATE ON PETITION
FOR REVIEW OF ORDER RE CHATTEL
MORTGAGE

To the Honorable Ernest A. Tolin, Judge of the
Above-Entitled Court:

I, Benno M. Brink, one of the Referees in Bankruptcy of said Court, before whom the above-entitled matter is pending under an order of general reference, do hereby certify to the following:

A. J. Bumb, the trustee herein, has duly filed his petition for the review of an order made in this matter by your Referee on May 27, 1958, and in which order your Referee ruled that the chattel mortgage hereinafter mentioned was valid and enforceable against the said trustee.

The Proceedings

The controversy which is here involved relates to a chattel mortgage which was given to L. E. McIntyre & Company by the bankrupt [31] and others on May 25, 1956. It is conceded that the said mortgage covered personal property owned by the bankrupt.

On August 13, 1957, the bankrupt made a general assignment for the benefit of creditors, to Ralph Meyer, who accepted the said assignment on August 19, 1957; during the course of the assign-

ment and prior to this bankruptcy the assignee sold all of the physical assets of the bankrupt, for the sum of \$28,775.00, free and clear of the aforesaid chattel mortgage; thereafter and prior to this bankruptcy McIntyre filed an action in the State Court for relief under the said mortgage; on October 29, 1957, a petition in involuntary bankruptcy was filed in this matter; on November 19, 1957, an order of adjudication was entered upon the said petition; on February 10, 1958, the assignee paid over all of the funds in his possession to the trustee in this matter.

On January 16, 1958, McIntyre filed herein a petition for an order to show cause requiring the trustee to show cause why he should not be substituted as a party defendant in the aforesaid State Court action in the place and stead of the bankrupt; an order to show cause was issued on the said petition, and on February 1, 1958, the trustee filed his answer and counterclaim in the premises; in his counterclaim the trustee asserted that the mortgage was unenforceable as against him upon several grounds; the principal ground of objection to the mortgage was that the description of the property mentioned in the mortgage was legally inadequate. Thereafter it was decided that the enforceability of the mortgage should be determined by this Court and not in the aforesaid State Court action; at the hearing which was had in this matter the trustee abandoned all of his objections to the mortgage excepting the one relating to the aforesaid

alleged inadequate description; at the conclusion of the hearing your Referee overruled the said objection [32] and held that the mortgage was valid and enforceable against the trustee of this estate; thereafter, on May 27, 1958, your Referee signed and filed his findings of fact, conclusions of law, and order in the matter, and it is from the said Order that this review is taken.

The Questions Presented

The questions presented by this review are these:

1. Does the record in this matter support your Referee's finding that the description of the property contained in the mortgage here in question is sufficiently definite to enable third parties, aided by inquiries which the instrument itself suggests, to identify the property covered by the mortgage?

2. Is paragraph 6 of your Referee's Findings of Fact a "Finding of Fact" or a "Conclusion of Law"? If it is a "Conclusion of Law," is it erroneous?

3. Should your Referee have made a finding specifying the particular mortgaged items of personal property which were sold by the assignee? (It appears that this point may not have been raised before your Referee. See letter of Robert H. Shutan dated March 24, 1958, and the proposed Findings of Fact, Conclusions of Law and Order re Chattel Mortgage therein mentioned.)

The Evidence

The evidence in this matter will be found in the Reporter's Transcripts and the Exhibits which are going up with this Certificate.

Referee's Findings of Fact and Conclusions of Law, and Order

The original of your Referee's Findings of Fact and [33] Conclusions of Law, and Order in this matter is herewith transmitted.

Papers Submitted

The following papers are transmitted herewith:

1. Petition for Order to Show Cause, filed Jan. 16, 1958.
2. Order to Show Cause, filed Jan. 16, 1958.
3. Answer to Petition and Counterclaim of Trustee, etc., filed Feb. 1, 1958.
4. Answer of L. E. McIntyre and M. H. McIntyre to Counterclaim, filed Feb. 13, 1958.
5. Order to Show Cause, filed Feb. 24, 1958.
6. Points and Authorities on behalf of L. E. McIntyre and M. H. McIntyre, etc., filed March 6, 1958.
7. Trustee's Points and Authorities, filed March 10, 1958.
8. Original of letter from Robert H. Shutan, dated March 24, 1958, and Proposed Findings of Fact, etc., filed March 25, 1958.
9. Stipulation, filed May 12, 1958.

10. Findings of Fact and Conclusions of Law, and Order, re Chattel Mortgage, filed May 27, 1958.

11. Petition for Review of Referee's Order.

12. Reporter's Transcript of Proceedings of March 10, 1958, filed Sept. 15, 1958.

13. Reporter's Transcript, Opinion of Referee, filed March 14, 1958.

14. McIntyre's Exhibits 1, 2, 3, 4 and 5.

Respectfully submitted this 7th day of October, 1958.

/s/ BENNO M. BRINK,
Referee in Bankruptcy.

[Endorsed]: Filed October 7, 1958, U.S.D.C.

[Title of District Court and Cause.]

REFEREE'S CERTIFICATE AMENDING
REFEREE'S CERTIFICATE ON PETI-
TION FOR REVIEW OF ORDER RE
CHATTLE MORTGAGE

To the Honorable Ernest A. Tolin, Judge of the
Above-Entitled Court:

I, Benno M. Brink, one of the Referees in Bankruptcy of the said Court, before whom the above-entitled matter is pending under an order of general reference, do hereby amend the Referee's Certificate on Petition for Review of Order re Chattel Mortgage which was filed in this proceeding on October 7, 1958, in the following particulars, to wit:

The statement made on lines 9 and 10 on page 2 of the said Certificate and which reads as follows:

“thereafter and prior to this bankruptcy McIntyre filed an action in the State Court for relief under the said mortgage”

is hereby deleted, and the following is hereby inserted in lieu thereof: [35]

“meanwhile, prior to the said sale, and prior to this bankruptcy, McIntyre filed an action in the State Court for relief under the said mortgage.”

Respectfully submitted this 20th day of October, 1958.

/s/ BENNO M. BRINK,
Referee in Bankruptcy.

[Endorsed]: Filed Oct. 20, 1958, U.S.D.C. [36]

In the United States District Court for the Southern District of California, Central Division

In Bankruptcy No. 82,754—T

In the Matter of

AMPSCO PRODUCTS OF CALIFORNIA, INC.,
Bankrupt.

ORDER AFFIRMING REFEREE'S
DECISION RE CHATTEL MORTGAGE

The hearing on the Petition of the Trustee herein for Review of the Referee's Order herein, which

said Order is entitled "Findings of Fact and Conclusions of Law, and Order, Re Chattel Mortgage," dated May 27, 1958, having come on regularly for hearing before the Honorable Ernest A. Tolin, on the 9th day of February, 1959, Messrs. Shutan & Feinerman, by Robert H. Shutan, Esq., appearing as attorney for the Trustee, Petitioner on Review, and Messrs. Forster & Gemmill, by John G. Gemmill, Esq., appearing as attorney for L. E. McIntyre and M. H. McIntyre, doing business as L. E. McIntyre & Company, Respondents on Review, and the Court having considered the said Petition, the Referee's Certificate on Review dated October 7, 1958, the Transcript of Oral Proceedings, the Exhibits admitted in evidence by the Referee, and the said Findings of Fact and Conclusions of Law, and Order, together with all other papers and documents referred to in and transmitted with said Certificate, and the Court having considered counsels' Points and Authorities filed herein, and the Court having heard oral argument and taken the matter under submission, and [39] having decided the same in favor of Respondents on Review, and against the Petitioner on Review, and the Court being fully advised;

It Is Hereby Ordered, Adjudged, and Decreed that the "Petition for Review of Referee's Order," insofar as the same seeks a reversal of the decision of the Referee, be, and the same hereby is, denied;

It Is Further Ordered, Adjudged, and Decreed that the "Findings of Fact and Conclusions of

Law, and Order, Re Chattel Mortgage'' dated May 27, 1958, of Honorable Benno M. Brink, Referee in Bankruptcy herein, is hereby ratified, confirmed, and approved, and is adopted in full as the Findings of Fact, Conclusions of Law, and Order of this Court, and that the decision of the said Referee, embodied therein, be, and the same hereby is, affirmed as the decision of this Court.

Dated March 11, 1959.

/s/ ERNEST A. TOLIN,
United States District Judge.

Affidavit of Service by Mail attached.

[Endorsed]: Filed March 11, 1959, U.S.D.C.

Entered March 13, 1959. [40]

[Title of District Court and Cause.]

NOTICE OF APPEAL

A. J. Bumb, Trustee in Bankruptcy and petitioner on review in the above-entitled proceeding, hereby appeals to the United States Court of Appeals for the Ninth Circuit from the Order Affirming Referee's Decision re Chattel Mortgage entered in this action on March 13th, 1959.

Dated: April 9th, 1959.

SHUTAN and FEINERMAN,

By /s/ ROBERT H. SHUTAN,
Attorneys for Appellant
A. J. Bumb, Trustee.

[Endorsed]: Filed April 10, 1959. [42]

[Title of District Court and Cause.]

APPELLANT'S STATEMENT OF
POINTS ON APPEAL

Comes now A. J. Bumb, Appellant and Trustee in Bankruptcy for the estate of Ampsco Products of California, Inc., a corporation, and presents herewith his points on which he intends to rely in support of his contention that the District Court erred:

1. The District Court erred in failing to reverse the Order of the Referee, dated May 27, 1958, and in affirming said Order.

2. The District Court erred in ratifying, confirming and approving the Findings of Fact and Conclusions of Law, and Order re Chattel Mortgage, dated May 27, 1958, of the Referee, and in adopting the same in full as the Findings of Fact, Conclusions of Law and Order of the District Court.

3. The District Court erred in respect to said Order, in that the Finding of Fact No. 6 (of the Referee and the District Court) is clearly erroneous in that said Finding 6 actually constitutes a conclusion, which conclusion is not supported by the evidence adduced at the hearing on said matter.

4. The District Court erred in respect to said Order, [48] in that the Findings of Fact (of the Referee and of the District Court) fail and omit to include a finding as to which of the items of furniture, fixtures and tooling equipment, which were sold by Ralph Meyer, as Assignee for the benefit of creditors, were covered by the subject chattel mortgage.

5. The District Court erred in respect to said Order, in that the Conclusion of Law No. 2 (of the Referee and of the District Court) is clearly erroneous, concluding that the subject mortgage was valid and enforceable against creditors, this estate, and the Trustee in Bankruptcy herein.

6. The District Court erred in respect to said Order, in that the Conclusions of Law Nos. 3 and 4 (of the Referee and of the District Court) are clearly erroneous, each being based upon the erroneous conclusion that the subject chattel mortgage is valid and enforceable.

Dated: June 19, 1959.

SHUTAN and FEINERMAN,

By /s/ ROBERT H. SHUTAN,

Attorneys for A. J. Bumb, Trustee in Bankruptcy
for the Estate of Ampsco Products of California, Inc., a Corporation, and Appellant.

[Endorsed]: Filed June 22, 1959. [49]

In the District Court of the United States, Southern District of California, Central Division

In Bankruptcy No. 82754—T

In the Matter of

AMPSCO PRODUCTS OF CALIFORNIA.

Los Angeles, Calif., March 10, 1958

REPORTER'S TRANSCRIPT
OF PROCEEDINGS

Appearances:

For Trustee:

SHUTAN and FEINERMAN, by
ROBERT H. SHUTAN.

For L. E. McIntyre and M. H. McIntyre, etc.:

FORSTER & GEMMILL, by
JOHN G. GEMMILL.

For Harvey Aikins and Mrs. Harvey Aikins:

SIGFRIED LEVITT.

The Referee: Ampsco Products of California.

Mr. Shutan: Ready for the Trustee.

Mr. Gemmill: Ready, your Honor.

The Referee: Let us have the record clear as to what we are proceeding on. We have on our calendar today a continued hearing on the order to show cause issued January 16, 1958, on the petition of L. E. McIntyre and M. H. McIntyre, doing business

under the firm name and style of L. E. McIntyre & Company, the order to show cause requiring the Trustee to show cause why certain relief should not be granted.

Then we have the answer to that petition and a counterclaim by the Trustee, which was filed February 1, 1958. Then we have the order to show cause issued February 24, 1958, which brought into the proceeding Harvey Aikins, Mrs. Harvey Aikins, John E. Brodbeck and Mrs. John E. Brodbeck, and the Security-First National Bank of Los Angeles. Who appears for the McIntyres?

Mr. Gemmill: I do—John G. Gemmill.

The Referee: Who appears for the Trustee?

Mr. Shutan: Shutan & Feinerman.

The Referee: And for Mr. and Mrs. Aikins? Do you have an attorney?

Mr. Aikins: Yes; but he is not present.

The Referee: Is he coming?

Mr. Aikins: I assume so. [2*]

The Referee: The point is, should we wait for him?

Mr. Aikins: I understood somebody would be here this morning.

The Referee: Mr. and Mrs. Brodbeck, are they here?

(No response.)

The Referee: Are they represented?

(No response.)

The Referee: Security-First National Bank of Los Angeles?

(No response.)

The Referee: Is the Bank represented by counsel? The Bank, of course, cannot appear in propria persona.

Now, let's see what our issues are. The petition filed by the McIntyres asks that the Trustee be required to appear in a certain Superior Court action. I think that position has now been abandoned.

Mr. Gemmill: I understood the Court to rule that this Court would determine the validity of the chattel mortgage, to which I have no objection.

The Referee: Then we go to the answer and the counterclaim and cross-complaint of the Trustee.

He states that the chattel mortgage is unenforceable as against the Trustee; that from a reading of the mortgage it is impossible to determine with any particularity whatsoever what assets of the bankrupt corporation are allegedly subject to the chattel mortgage; and that the assets were sold. [3]

I assume that was done, but that does not decide the question of the validity of the mortgage; it is simply determining who is entitled to the proceeds of the sale, is that right?

Mr. Shutan: Yes.

The Referee: That is the only purpose of that allegation. Let's go down to the counterclaim (Reading):

“That said mortgage failed to comply with the requirements of the law as pertaining to

publishing notice of intention to execute a chattel mortgage, no such notice having been filed prior to the execution and recordation of such chattel mortgage.” [4]

The Referee: Well, Mr. Shutan, upon what allegation in your counterclaim could the Court sustain a conclusion that notice was necessary? Notice is not always necessary.

Mr. Shutan: There is no allegation in the counterclaim which relates to publishing of notice, but it seems to me that we put it into issues there by declaring it can be resolved by the statement which I wish to make the Court. We have been satisfied since the preparation of this counterclaim that the parties did publish a notice of intention in relation to this mortgage and did record such notice of intention, so that the Trustee is not going to belabor that point, and withdraws to that extent that part of that objection. There was a notice published and recorded in relation to this mortgage, and we are not challenging the ten-day period.

The Referee: All right. That disposes of that. Do you still rely upon your contention that there was undue and unreasonable delay in recording it?

Mr. Shutan: We rely on that in this limited sense—in count two of paragraph four that the mortgage, which is already before the Court, by way of an exhibit, speaks for itself—we make the contention that there was undue delay. In relation to those dates the Trustee does not intend to do

more than present the mortgage and the dates to the Court, and we will submit it on that basis. [5]

The Referee: All right. You still rely upon your contention that the description is insufficient?

Mr. Shutan: In essence that is the Trustee's case, and we very strongly urge that point.

The Referee: Miss Kendall, I presume you are interested because Mr. Meyer is assignee?

Miss Kendall: Yes.

The Referee: He was named as defendant in the State Court action?

Miss Kendall: Yes.

The Referee: Other relief is asked of Mr. Meyer other than he pay the amount of money represented by the mortgage?

Miss Kendall: That was it.

The Referee: Do you think it is necessary for Mr. Meyer to be represented by counsel?

Mr. Gemmill: I don't think it makes any real difference.

The Referee: If this Court determines the validity or non-validity of the mortgage I don't imagine you would press the matter in another suit against Mr. Meyer on the same set of facts. If we held your mortgage is not valid you would not go over to the Superior Court and attempt to prove it valid as against Mr. Meyer?

Mr. Gemmill: No, I don't think we could.

Miss Kendall: I will be glad to be excused. [6]

Mr. Gemmill: If it is held to be invalid I don't think Mr. Meyer is concerned about it.

The Referee: In any event, Mr. Meyer has been superseded by the Trustee.

Mr. Gemmill: I believe that is correct.

The Referee: Mr. Meyer has filed his account. If he has turned over everything to the Trustee there can be no cause of action against Mr. Meyer.

Mr. Gemmill: I think the only instance would be where the funds he turned over to the Trustee were not sufficient to discharge the mortgage. I think there was a conversion by Mr. Meyer in selling the mortgage. However, it is not an issue here.

The Referee: You did not allege it.

Mr. Gemmill: No, because at the time the court proceedings were commenced he had not sold it.

The Referee: Was this sale made after bankruptcy?

Miss Kendall: No. The property had been sold prior to the institution of the State Court proceeding, and after notice being given to Forster & Gemmill, and acknowledged by them of intent to sell—that had been accomplished.

Mr. Gemmill: That is not a correct statement. The notice to us was that they intended to take bids.

The Referee: Well, Miss Kendall, you exercise your own discretion and judgment as to whether or not Mr. Meyer's [7] interests require your presence here. Technically, I don't think Mr. Meyer is a party to the proceedings before this Court. I don't remember reading a supplemental order to show cause here that he was included as a respondent.

Miss Kendall: He was not, but I think he is a proper party.

The Referee: If you wish to intervene we will consider that.

Miss Kendall: No, I think Mr. Meyer's interests will be adequately protected by the statement of the gentleman.

The Referee: Please don't think the Court is trying to get rid of you. You are welcome to stay.

Miss Kendall: That is very kind. There are sufficient moneys to pay the mortgage in full and he will turn it over to the Trustee.

The Referee: All right.

(Miss Kendall leaves the court room.)

The Referee: I think that under the pleadings as they are constituted that counsel for the Trustee can go forward. Just a moment. Has counsel for Mr. and Mrs. Aikins come in?

Mr. Levitt: Yes, your Honor.

Mr. Shutan: Your Honor, with the copy of the chattel mortgage which is attached, I believe, to the [8] original petition of the McIntyres, and is before the Court in this proceeding, although I would like to double-check that——

The Referee: Well, just a moment—there is attached to the McIntyres' petition filed January 16, 1958, a photostat of a note dated May 25, 1956, and photostat of a mortgage of chattels dated May 25, 1956. All right.

Mr. Shutan: May I address counsel and ask if he wishes to enter into a stipulation that the Trus-

tee stipulates that a copy of the mortgage may be considered as evidence in this case?

Mr. Gemmill: I will so stipulate.

Mr. Shutan: The Trustee rests—a prima facie case.

The Referee: All right. Proceed.

Mr. Gemmill: Your Honor, I have obtained for counsel photostat copy of intended mortgage showing recorded date, and affidavit of publication of the intent to mortgage. He has stipulated with me that it may be stipulated that the photostated copy can be introduced without further foundation. Is that right?

Mr. Shutan: I have stipulated to a waiver of the foundation—yes, that part is correct.

Mr. Gemmill: I now offer in evidence photocopy of the original notice of intended mortgage, which is dated May 24, 1956, and shows on its face to have been recorded May 28, 1956, in Book 51301, page 310, Official Records [9] of Los Angeles County, California. I will offer that in evidence as McIntyre's Exhibit.

The Referee: McIntyre's Exhibit No. 1.

Mr. Shutan: I object to that—it now irrelevant.

The Referee: Objection overruled.

Mr. Gemmill: I now offer in evidence affidavit of publication executed by Dorothy Holt, under date of June 4, 1956, showing the publication of the notice of intended mortgage in the Compton Herald American and the Compton Herald.

Mr. Shutan: Objected to, on the same ground.

The Referee: Objection overruled. McIntyre's No. 2.

Mr. Gemmill: I subpoenaed certain documents from the escrow bank, and I understand that they have a representative here with the escrow file.

I will call Mr. Browning.

GARY BROWNING,

a witness called on behalf of petitioner, having been first duly sworn, testified as follows:

The Referee: Will you give us your name?

A. Gary Browning.

Direct Examination

By Mr. Gemmill:

Q. What is your business or occupation?

A. I am manager of the Broadway and Florence Branch of the Security-First National Bank.

Q. And you have some documents before you. What is the nature of them? [10]

A. The escrow file concerning this matter.

Q. And the number is what?

A. 129-5912.

Q. Who are the parties to the escrow?

A. Ampsco Products of California, and L. E. McIntyre & Company.

Mr. Gemmill: Counsel, in this escrow, among other things, are inventories which were initialed by Mr. McIntyre and Mr. Brodbeck and Mr. Aikins. I wonder if it may be stipulated that photostatic

(Testimony of Gary Browning.)

copy of the inventory may be substituted in place of the original, which I propose to offer? I am not asking for a stipulation that they be admitted—simply that they are photostatic copies which may be used in place of the original.

Mr. Shutan: I will stipulate to that extent, counsel.

Q. (By Mr. Gemmill): I call your attention to the several lists—the first is headed **Office Furniture and Fixtures**; next, **Inventory of Automatic Screw Machine Repair Parts and Tooling**; and, next, **Inventory of Inspection Equipment**; and I ask you if those documents are part of the escrow file in this matter.

Mr. Shutan: Objected to, immaterial and irrelevant as to the description of the mortgaged assets so far as it pertains to the Trustee in Bankruptcy.

The Referee: Objection overruled. The question is whether or not certain papers, or are certain papers part [11] of the escrow file. What is your answer?

A. Yes, sir; they are part of the escrow file.

Mr. Gemmill: I now offer in evidence, under the stipulation that photostats may be received in lieu of originals, the inventories which I have just referred to as McIntyre's next in order.

Mr. Shutan: I will object to the introduction of these lists of inventory as being irrelevant to the issues presented by the proceeding before the Court, which challenges the sufficiency of the description in the chattel mortgage, which inventory lists have

(Testimony of Gary Browning.)

been submitted into the escrow, assuming that it was. It does not relate to what notice was given to the creditors of the assets which are subject to chattel mortgage, and therefore is irrelevant to this proceeding.

The Referee: Mr. Shutan, the theory of the case as interpreted by counsel for McIntyre I think is quite clear—he is going to maintain that from the mortgage you go to the escrow, and in the escrow you find the detailed description of the items that are covered by the mortgage; and, so, all evidence in that connection is admissible; but then the Court's problem is to determine whether or not the entire transaction, taken as a whole comes within the provision of law with respect to adequate description of property. It is admissible, but what its effect will be we don't know. McIntyre's Exhibit No. 3. [12]

Mr. Gemmill: There were original escrow instructions. This file contained May 25, 1956, and an amendment, June 12, 1956, and also an amendment of June 12, 1956, is that correct?

A. Yes.

Mr. Gemmill: Under the stipulation, your Honor, the photostat may be received in lieu of the original—the original escrow instructions and two amendments, of the dates mentioned—I would like to offer those in evidence as McIntyre's next in order.

Mr. Shutan: I make the same objection—irrelevant and immaterial in relation to the issues.

(Testimony of Gary Browning.)

The Referee: Objection overruled. These instruments, photostats, are McIntyre's Exhibit No. 4.

Cross-Examination

By Mr. Shutan:

Q. Is this the entire escrow file? A. Yes.

Q. Which is the beginning?

A. They are chronologically arranged.

Q. Can you tell me from these papers the date that the escrow was opened?

A. May 25, 1956.

Q. And the date that the mortgage was recorded is what? I think we have that—June 14, 1956—is that correct?

Mr. Gemmill: That is the correct date. The file [13] would not necessarily show the recording date.

The Referee: The recording date is on the photostat of the mortgage, which is a part, by stipulation, of the record here.

Mr. Gemmill: That is correct.

The Referee: Were you in the escrow department of the office of the Security-First National Bank at the time of this transaction? Are you familiar with the transaction?

A. I did not handle the transaction. However, I am somewhat familiar with it, being manager of the branch at the time this escrow was handled.

Q. Have you handled a number of escrows involving chattel mortgages? A. Yes.

(Testimony of Gary Browning.)

Q. Does your bank have a general practice in relation to lists of inventory in relation to mortgages, for processing through your escrow department?

Mr. Gemmill: I don't think there is any detriment in that one way or the other, but I think we are getting into side issues and it is immaterial here as to the policy of the bank.

The Referee: Objection overruled. Let us see what he developes.

Q. (By Mr. Shutan): To make the question perhaps a little bit clearer, I am talking about the policy [14] as to whether or not lists of inventories are attached to the mortgage you send for recordation on behalf of the parties to the escrow.

A. It is the policy to have a list of the exhibits which they ask for in the escrow.

Q. Well, I notice, Mr. Browning, that in the original escrow instructions of May 25th, it states on line 38—"Copies of inventory of all personal property located at 224 East Palmer Avenue, Compton, California, to be handed you by borrower and approved by lender herein." According to previous testimony a copy of inventory was put in the escrow. If no other instructions had been given to you would you, in the ordinary course of your bank's escrow—would the bank have recorded the inventory list along with the mortgage?

A. If it had been attached and made part of the mortgage?

(Testimony of Gary Browning.)

Q. Your Bank prepared this chattel mortgage?

A. Yes.

Q. Would your Bank, on the basis of the original instructions, have attached a copy of the inventory list to such chattel mortgage, making it a part thereof?

A. I assume we would unless we were instructed otherwise.

Q. Well, then, let us look at this Exhibit No. 4, I believe, the amendment to the escrow instructions. It is [15] dated June 12, 1956. There are two of them. I am referring to the one that starts, "My previous instructions in the above-numbered escrow are hereby modified—supplemented in the following particulars only." Then it states: "You are not to attach a list of the inventory to the chattel mortgage being recorded, and the initials of borrower and lender on the copy of note and chattel mortgage being retained in your files constitute full approval of same."

If you had not received written instructions on that would you, in following your normal policy—would your bank have attached a list of inventory to the mortgage?

The Witness: "Normal policy" is a little difficult for me to say what it would be, inasmuch as I was not handling the escrow.

The Referee: Well, Mr. Witness, if you don't know you may say so. I would rather you did that than simply to guess at it.

(Testimony of Gary Browning.)

The Witness: I don't know.

Q. (By Mr. Shutan): All right. Now, I notice here a paragraph which reads as follows:

“You are hereby instructed not to file a new notice of intended mortgage on account of the mortgage not being held on the date specified in recorded notice of intended [16] mortgage, and your bank is relieved of all responsibility as to the validity, regularity and sufficiency of the proceeding and of the mortgage.”

From your examination of this file and from whatever familiarity you have with the matter, can you tell me—do you know why that was put in or to what it refers?

A. I assume it would refer to any liability we might have by not having this recorded at the correct time or at the time originally stated, because of some delay.

Q. What was the time it was supposed to be recorded—can you tell or can you point out to me in the original escrow instructions?

The Referee: The escrow instructions are in evidence, as McIntyre's Exhibit No. 4, and commencing on line 53, of page 1, we find:

“You will be handed a Notice of Intended Mortgage regarding said Chattel Mortgage. You will file said notice for record in the above-named County, at least ten days before the sale date named herein. Said notices shall

(Testimony of Gary Browning.)

provide for the sale, transfer, and assignment (and/or mortgage), and payment of the consideration on June 12, 1956, at 10:00 o'clock a.m. at the Escrow Department of the Broadway & Florence Branch of Security-First National Bank of Los Angeles, 7124 South Broadway Street, Los Angeles, California."

Mr. Shutan: These instructions were given to you [17] June 12th, which had been the date set by the original instructions for the execution of the mortgage and conclusion of the mortgage transaction, is that correct?

A. They are dated June 12th.

Q. And is it correct that no other notice of intention to mortgage was filed than the one which is McIntyre's Exhibit No. 1, here, is that correct?

A. I believe that is true. [17½]

Q. I see some correspondence here. There is a letter to R. G. Browning, Manager of Security-First National Bank—that is you? A. Yes.

Q. You were then and now are the manager?

A. Yes.

Q. I call your attention to an item in your escrow file. It appears to be a copy of form of transmission notice, to L. E. McIntyre, dated June 25, 1956, apparently a note for "twenty-seven five," and various policies. I see a personal property encumbrance guaranty, 453300. Was there a policy on this mortgage?

A. Offhand, I don't know what that is.

(Testimony of Gary Browning.)

Mr. Shutan: I have no further questions.

The Referee: Does anybody have any questions?

Mr. Gemmill: Yes.

Redirect Examination

By Mr. Gemmill:

Q. In response to a question on cross-examination you stated that you examined the provisions in the escrow instructions which said "Bank will not be responsible for failure to record in proper length of time." You stated you assumed that to be for the purpose which is stated there. As a matter of fact, you have no independent knowledge concerning any delay with respect to the recording of the chattel mortgage, do you? A. No. [18]

Q. The only things you know are what are shown in the file itself, is that correct?

A. Yes.

Mr. Gemmill: I have no further questions.

The Referee: Are there any questions?

Mr. Shutan: No, sir.

The Referee: All right. May Mr. Browning be excused?

Mr. Gemmill: Yes, so far as we are concerned.

Mr. Shutan: Yes, sir.

L. E. McINTYRE,

a witness, having been first duly sworn, testified as follows:

The Referee: I don't think you need prove the execution of the document. Is there any doubt about that?

Mr. Shutan: No. We are not challenging the execution.

Mr. Gemmill: These inventories were not executed. However, they were initialed. If Mr. Shutan will stipulate that the initials which appear on each of the inventories are the initials of Mr. McIntyre and Mr. Aikins and Mr. Brodbeck, being the managing officers of the bankrupt corporation, then I would be willing to forego establishing that fact.

Mr. Shutan: No, I cannot stipulate.

The Referee: All right. So far as the formal documents [19] are concerned, proof of execution may be given as to inventories. You may proceed.

Direct Examination

By Mr. Gemmill:

Q. Mr. McIntyre, I will show you McIntyre's Exhibit No. 3, and call your attention to the first page of that exhibit, which contains certain handwritten initials; and, also to the page therein Inventory of Inspection Equipment, which contain such initials; and to the sheet entitled "Office Furniture and Fixtures," which contains such initials. Now, in each instance, will you state whose initials appear first? A. My initials appear first.

(Testimony of L. E. McIntyre.)

Q. You placed those there while the documents were in escrow and before the close of the escrow?

A. Yes.

Q. Whose initials appear thereafter?

A. The second is J. E. Brodbeck; and the third is Mr. Aikins.

Q. Are you familiar with their handwriting and initials? A. I am.

Mr. Shutan: May it be deemed that I have a running objection to all questions relating to this inventory list, because I feel there has not been a proper foundation laid? I feel that all documents relating to the escrow itself, and particularly to the inventory list, are irrelevant and immaterial. If my objection is deemed [20] to be running it will save time.

The Referee: The record may show your objection to all questions concerning the escrow or in the escrow. The objection is overruled.

Mr. Gemmill: I have no further questions.

Recross-Examination

By Mr. Shutan:

Q. Well, Mr. McIntyre, what was the obligation secured by your chattel mortgage?

Mr. Gemmill: Your Honor, I think the document is the best evidence of that fact.

The Referee: Objection sustained; it is in evidence.

Mr. Shutan: I have no further questions.

The Referee: Any other questions?

Mr. Gemmill: I have no other questions.

The Referee: Let's take a recess.

(Whereupon a recess was taken, after which the following proceedings were had:)

The Referee: Well, as far as the delay in recording is concerned, I don't think you have got a case, because the mortgage is dated May 25, 1956; it was acknowledged by the officers of the mortgagor corporation. On June 8, 1956, there was a notice of intention filed, which made it impossible for the escrow to deliver that mortgage before June 12th, and it was recorded June 14th; and, so there was no delay there.

The one point that you abandoned you probably want [21] to talk about some more, and that is the question of the notice of intention, and that may be suggested by the last escrow instruction. Do you want to revive that?

Mr. Shutan: Yes. I would like to revive that because, frankly, it had not occurred to me until that evidence was produced that the transaction of the mortgage was not consummated on the date that the creditors were advised by the notice. I haven't researched that particular point.

The Referee: Then, if you are going to get back to that you get back to your own pleading, which would appear to be insufficient—your pleading does not bring this corporation within the type of persons or entities which are required to give notice.

Mr. Shutan: Well, I would ask leave to amend

the pleading to make that allegation, and the allegations contained in it would not contain any material which would surprise.

The Referee: What would you allege?

Mr. Shutan: That the bankrupt was engaged in a business which was within the requirements of the Code.

The Referee: What kind of business?

Mr. Shutan: A machine shop—a machinist.

The Referee: A machinist?

Mr. Shutan: Yes.

The Referee: That is one of the specified businesses? [22]

Mr. Shutan: Yes.

The Referee: All right. Let us assume that you amend or supplement and allege that the bankrupt at the time of the execution of the mortgage was a machinist, and let us assume that that brought you within section 3440.1 of the Civil Code, you would then be suggesting that the transaction just be consummated on the date mentioned in the notice; that there can be no delay beyond that date unless a new notice is given.

Mr. Shutan: That appears to be the only point I would have. As I indicated before, I am not prepared on that point today. I don't know whether I am sure that the cases will cover that particular point. I don't know whether they hold that a failure to close the deal on the date indicated in the notice is fatal to the validity of the execution of the mortgage.

The Referee: Just a moment. Section 3440.1, among other things, provides:

A mortgage of the fixtures or store equipment of a—machinist—will be conclusively presumed to be fraudulent and void as against the existing creditors of the mortgagor, unless at least ten days before the consummation of such mortgage—the intended—mortgagee shall record in the office of the county recorder in the county or counties in which said stock in trade, fixtures [23] or equipment are situated a notice of said intended—mortgage, stating the name and address of the intended mortgagor and of the intended mortgagee, and a general statement of the character of the merchandise or property intended to be—mortgaged, and the date when and the place where the purchase price or consideration, if any there be, is to be paid.”

As to the factual situation—on the date of June 12, 1956, there was an escrow instruction dated that day. Now, that is where the evidence stops. I don’t know what happened after that. I don’t know whether the deal was completed on June 12 or not. It does not say that the mortgage has to be recorded on June 12—the law does not say that; and, so, I don’t know. The mortgage was recorded June 14th. If the transaction was completed on June 12th and the mortgage recorded June 14th, as I point out, there would not be any unreasonable delay.

Mr. Shutan: I think the instruction of June

12th gave an overwhelming inference that the deal was not concluded on June 12th.

The Referee: You mean a suspicion?

Mr. Shutan: I would call it what I called it.

The Referee: Well, in this Court we do not invalidate otherwise valid liens upon either suspicion or an inference. It must be upon a preponderance of evidence.

Mr. Shutan: We have challenged the mortgage, and [24] there has been no evidence introduced that it was concluded on the day advertised. We may be talking about the burden of proof rather than the degree of inference. We have challenged and notified the mortgagee of our attack on the mortgage, and there has been no indication it was concluded on June 12th.

Mr. Gemmill: Your Honor, it is our position that it makes no difference whether or not the transaction was concluded on the 12th; nobody could possibly be hurt by the failure to do it on the 12th or 14th or a subsequent date as long as the Code was complied with—of giving notice of intended mortgage and thereby giving creditors an opportunity to come in and levy their attachments or put their claims in escrow. * * *

I would like to offer into evidence this escrow sheet. I do represent that this is a photostat copy of a photostat copy which was sent to me by the escrow department; and I ask counsel if he will waive formality of foundation.

Mr. Shutan: I will waive formality of foundation and not make any objection to it coming in at

this time, but I am not quite sure how it relates to the particular question that the Court has raised.

The Referee: Is there any objection?

Mr. Shutan: I will object on the ground that it is irrelevant to this particular issue. Frankly, I would waive [25] my objection if I could see in here that it would assist us.

The Referee: Objection overruled. This McIntyre's Exhibit No. 5.

Mr. Gemmill: Your Honor, I did not show that document to counsel.

The Referee: All right—take a look at it.

Mr. Shutan: I do not find on here a date that indicates date of preparation.

The Referee: You find various dates—on the lower right-hand corner you will find settlement date, June 11th.

Mr. Shutan: This document indicates that the mortgage was recorded on the 15th, but, actually, the mortgage bears the date of the 14th.

The Referee: That is right. Do you want to do anything, Mr. Shutan, on this point?

Mr. Shutan: Yes, your Honor, I would like an opportunity to submit to counsel and the Court—if the Trustee is going to press this point—a brief memorandum on the law.

The Referee: I will say to you now that I will overrule your contention simply on the ground that your pleading does not state a cause of action.

Mr. Shutan: Well, I had already assumed that I had gotten into the record my desire. [26]

The Referee: You had better make it formally.

Mr. Shutan: I formally move that the Trustee be permitted to amend the pleading, or that the pleading deemed to be amended.

The Referee: No.

Mr. Shutan: That the Trustee be permitted to amend the pleading to include the allegation that respondents, L. E. McIntyre, and so forth, the individuals doing business as a co-partnership, as named herein—that they were conducting a business—pardon me—that the bankrupt, Ampsco, was conducting a business within the terms and meaning of section 3440.1 of the Civil Code of California, in that such business was that of a machinist; and that under California law, and particularly section 3440.1 the parties to such chattel mortgage were required to file a notice of intention within the requirements of such section, and that they did not file a notice of intention which complied with their obligation under the statute; and that by virtue of their failure—the parties' failure, to comply with the statute the subject chattel mortgage is invalid, particularly against third parties, including the Trustee.

The Referee: Is there any objection to the motion to amend?

Mr. Gemmill: Yes, there is, your Honor. I take it that counsel is submitting an amendment which is designed [27] to conform to the proof. I think it is axiomatic that unless the proof is along the lines that the amendment proposed goes, then it is not proper to amend the pleadings. There is no evidence here whatsoever as to the business in which

the bankrupt is engaged. Furthermore and probably more seriously, the proposed amendment states a conclusion which is not consistent with the fact, namely, that there was not a compliance with section 3440.1 of the Civil Code. We contend that there was compliance with the letter, that is, the exact language of that section, namely, there must be a notice published within the number of days before the event occurs.

(Discussion.)

The Referee: Motion to amend is denied. You are attempting to proceed, Mr. Shutan, under a technical statute, you are attempting to invalidate a mortgage, purely on technical grounds, without any real reference to equity or justice. Whenever you come into court on a matter like that you are not entitled to any favors by the court at the expense of the other side. As counsel points out, you have no evidence as to the kind of a business this is, which would mean you would have to have a continuance and bring everybody back here. I am satisfied that under the circumstances of the case your motion to amend, in the particulars you have set forth, must be denied, and it is so denied. [28]

All right. Now, the Court will hold that the notice required by section 3440.1 of the intention to give the mortgage which was here given—that that notice was, in fact, given as required by the section, 3440.1.

Now we get down to the final, and what Mr. Shutan asserts is the big question, namely, that of

description. There is not any doubt at all as to what the law of California is.

(Discussion.) [29]

The Referee: I am ready to rule, gentlemen. The petition of the Trustee is overruled. There is no equity here, Mr. Shutan. This is just hard, tight-fisted law under the terms of which something may be taken away from a person who in good faith paid a valuable consideration for it purely upon the technicality of a statute. And, so, it is not a case which calls for the exercise of any equitable jurisdiction that the Court may have; and, as I have already indicated, by denying your motion to amend, this is the sort of a case where the moving party, or the plaintiff, must watch out for himself and not expect any special consideration from the Court.

On the other hand, of course, the Court must not permit any sympathy for the claimant or prejudice against the one who resists a claim to interfere with his judgment. He must decide it upon the facts and the law, whatever his private opinion of the law may be as he finds such facts and law to be in a given case.

Now, I overruled the Trustee's petition on two grounds—one—that the description as given on the mortgage it itself is self-sufficient—it is a description of the fixtures, machinery, tooling equipment located at the address given.

Now, as we have all been conceding all morning [30] long here. It is only the one word that was typed in here by the person who typed the mortgage

that give us any trouble at all. That is the word "certain."

Now, if, as Mr. Shutan has rhetorically inquired, it had said "some" or "part," then the Court's ruling on this point which we make simply for the purpose of identification, referred to as point one, would have to be different because there it would indicate something less than the whole. If it said "some" or a "portion" or a "part," thereof, there is some doubt as to the construction to be placed on this word "certain."

But I hold that in a technical statute such as we have here, and in a proceeding such as we have here, the doubt must be resolved in favor of the one who has the equitable side of the case, which in this case is the mortgagee.

Now, if we had a lawsuit where somebody had purchased some of the fixtures, machinery and equipment for an adequate consideration upon the advice, for instance, of an attorney that this mortgage by its terms did not cover the items purchased, then we would have a different equitable situation. But in a case such as we have here where this point has come up because of the filing of an involuntary petition in bankruptcy and the subsequent adjudication, which vested in the Trustee, the rights, remedies and powers of a lien of a creditor holding [31] a lien by legal or equitable proceeding, I hold that where doubt exists the mortgage should be resolved in favor of the mortgagee.

Now, this is the doubt—does the word "certain" mean "some" or does it in this case mean "all"?

We have the word "certain" twice. It says, "the Mortgagor mortgages to the Mortgagee all that certain personal property." Now, what is meant by that "certain"? That means all of the property described after the words "to wit," because it says he mortgages "all that certain personal property situated and described as follows, to wit." Of course, there you have the interposition of the word "all," and that tends, of course, to clarify the meaning of the word "certain." This word "certain" can mean, as I say, either a part or portion, or it can be a word of description, namely, it could mean and it could be the equivalent, even, of the word "the."

It could be read this way—"That the Mortgagor mortgages to the Mortgagee all that certain personal property situated and described as follows, to wit: the fixtures, machinery and tooling equipment located at 224 East Palmer Avenue."

Now, we have a lot of fine print in this mortgage, and among the fine print we find a paragraph that is designated by the letter "(1)." It reads: "That all additions, increases, repairs to, improvements and [32] replacements of said mortgaged property shall immediately become subject to the lien of this mortgage and to all the provisions thereof."

I have not taken time to read the rest of the fine print, but I will take it for granted that there is nothing in it that contradicts that particular paragraph. There may be something in it that would strengthen it.

Now, reading the whole mortgage together, as we have to do, isn't that almost proof conclusive

that when they used the word "certain" that they meant the fixtures, machinery and tooling equipment?

The only thing that will bother you there is the additional words "and located at 224 East Palmer Avenue, in the City of Compton, State of California." But I am satisfied that a construction that the mortgage covered all of the fixtures, machinery and tooling equipment at the address mentioned does not do violence to the language that is used, although some other construction might be possible from the language.

Now, point two. If there is any insufficiency of description, the exact description can be ascertained by information disclosed in the instrument itself.

I go a little farther than counsel, but I will go along with him as far as he goes. You have a very definite address—"224 East Palmer Avenue, in the City of Compton, State of California." An inquiry at that address [33] would have led to the escrow, and the escrow had the detailed description of the mortgaged property in its file, and that description is identified in the supplemental escrow instructions. This exhibit "McIntyre's No. 3" is captioned "Inventory," and the inventory is referred to in the supplemental instructions, so that you have the whole thing.

I say I go along as far as counsel goes, but I go farther. On behalf of the mortgagor the mortgage was executed by its president and its vice president, and inquiry at the address given would have led to one or the other or both of these men,

who, again, could have said, "There is an escrow and in that escrow you will find the detailed description."

I will take it for granted that findings are desired.
Mr. Shutan: Yes, your Honor.

[Endorsed]: Filed September 15, 1958. [34]

[Title of District Court and Cause.]

CERTIFICATE BY THE CLERK

I, John A. Childress, Clerk of the above-entitled Court, hereby certify that the foregoing documents together with the other items, all of which are listed below, constitute the transcript of record on appeal to the United States Court of Appeals for the Ninth Circuit, in the above-entitled case; and that said items are the originals unless otherwise shown on this list:

A. Names and Addresses of Attorneys.

Petition for Order to Show Cause, filed 1/16/58.

Order to Show Cause, filed 1/16/58.

Answer to Petition and Counterclaim of Trustee, filed 2/1/58.

Answer of L. E. McIntyre and M. H. McIntyre to Counterclaim, filed 2/13/58.

Findings of Fact and Conclusions of Law and Order, Re Chattel Mortgage, filed 5/27/58.

Petition for Review of Referee's Order, filed 5/31/58.

Referee's Certificate on Petition for Review of Order Re Chattel Mortgage, filed 10/7/58.

Referee's Certificate Amending Referee's Certificate on Petition for Review of Order Re Chattel Mortgage, filed 10/20/58.

Minute Order 2/9/59 re hearing on petition on review.

Minute Order 3/3/59 re affirming ruling of Referee, etc.

Order Affirming Referee's Decision Re Chattel Mortgage, entered 3/13/59.

Notice of Appeal, filed 4/10/59.

Motion to extend time for filing record and docketing appeal and Order thereon, filed 5/20/59.

Designation of contents of record on appeal, filed 6/22/59.

Appellant's Statement of Points on Appeal, filed 6/22/59.

Appellees' Designation of additional items to be included in record on appeal, filed 6/25/59.

B. McIntyre Exhibits 3 and 4.

C. One volume of Reporter's Official Transcript of proceedings had on: March 10, 1958.

D. (Copy) Docket Entries.

Dated: June 26, 1959.

[Seal]

JOHN A. CHILDRESS,
Clerk;

By /s/ WM. A. WHITE,
Deputy Clerk.

[Endorsed]: No. 16515. United States Court of Appeals for the Ninth Circuit. A. J. Bumb, Trustee in Bankruptcy of the Estate of Ampsco Products of California, Inc., Bankrupt, Appellant, vs. L. E. McIntyre and M. H. McIntyre, Doing Business as L. E. McIntyre & Co., Appellees. Transcript of Record. Appeal from the United States District Court for the Southern District of California, Central Division.

Filed and Docketed: June 29, 1959.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for
the Ninth Circuit.

No. 16515

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

A. J. BUMB, Trustee in Bankruptcy of the Estate of
AMPSCO PRODUCTS OF CALIFORNIA, INC., Bankrupt,
Appellant,

vs.

L. E. McINTYRE and M. H. McINTYRE, doing business as
L. E. McINTYRE & Co.,
Appellees.

APPELLANT'S OPENING BRIEF.

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FILED

NOV 16 1959

PAUL P. O'BRIEN, CLERK

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No. 16515
IN THE
United States Court of Appeals
FOR THE NINTH CIRCUIT

A. J. BUMB, Trustee in Bankruptcy of the Estate of
AMPSCO PRODUCTS OF CALIFORNIA, INC., Bankrupt,
Appellant,

vs.

L. E. MCINTYRE and M. H. MCINTYRE, doing business as
L. E. MCINTYRE & Co.,

Appellees.

APPELLANT'S OPENING BRIEF.

Jurisdictional Statement.

(a) The United States District Court for the Southern District of California had jurisdiction by virtue of 11 U. S. C. §11, Bankruptcy Act, Sec. 2 (Creation of Courts of Bankruptcy and Their Jurisdiction). The matter came before the District Court upon the filing of a petition in involuntary bankruptcy. An order of adjudication was entered upon the said petition by the District Court. The petition represented that the bankrupt's principal place of business had been within the judicial district of the District Court of the United States, Southern District of California, for a longer period of the six months immediately preceding the filing of the petition than in any other judicial district.

(b) This Court has jurisdiction by virtue of 11 U. S. C. §47, Bankruptcy Act, Sec. 24. The amount in controversy is in excess of \$500.00, the appellant

having been ordered to pay to appellee the total sum of \$19,221.42, plus interest which will accrue at the rate of 10% per annum on the principal sum of \$17,474.02 from and after July 1, 1958 [Tr. 19, 20].

(c) The Referee's findings of fact, conclusions of law and order re chattel mortgage were signed and entered on May 27, 1958 [Tr. 20]. On May 31, 1958, appellant filed its petition for review of Referee's order under the provisions of Bankruptcy Act, Sec. 2, 11 U. S. C. § 11 and Bankruptcy Act, Sec. 39c, 11 U. S. C. § 67c [Tr. 20-22]. On October 7, 1958, the Referee filed his Certificate on Review [Tr. 23]. On October 20, 1958, the Referee filed his Certificate Amending Referee's Certificate on Review [Tr. 27]. After a hearing, the United States District Court for the Southern District of California made its Order Affirming Referee's Decision re Chattel Mortgage, which order was entered on March 13, 1959 [Tr. 28]. On April 10, appellant filed a notice of appeal to the Court of Appeals for the Ninth Circuit [Tr. 30].

Statement of Case.

Appellant in this matter is the trustee in bankruptcy of the estate of Ampsco Products of California, Inc. Said bankrupt corporation, on August 13, 1957, made a general assignment for the benefit of creditors to Ralph Meyer, who accepted the assignment on August 19, 1957. In the course of the assignment, the assignee sold all of the physical assets of the bankrupt corporation for the sum of \$28,775.00, free and clear of encumbrances. Prior to said sale and prior to this bankruptcy, L. E. McIntyre & Co. filed an action in the State Court relating to a chattel mortgage which was given to L. E. McIntyre & Co. by the bankrupt. On October 29, 1957,

a petition in involuntary bankruptcy was filed in this matter. An order of adjudication was entered upon the said petition and the assignee paid over all of the funds in his possession to the trustee in bankruptcy. L. E. McIntyre & Co. filed a petition before the Referee in Bankruptcy for an order to show cause requiring the trustee in bankruptcy to show cause why he should not be substituted as party defendant in the aforesaid State Court action in the place and stead of the bankrupt [Tr. 3-7]. After said order to show cause was issued, the trustee in bankruptcy filed his answer opposing the effort to involve the trustee in the State Court suit [Tr. 7]. The trustee in bankruptcy also filed a counter-claim seeking to have the subject chattel mortgage declared invalid [Tr. 7-11]. Thereafter, it was agreed and ordered [Tr. 19] that the question of the validity of the mortgage should be determined by the Bankruptcy Court and not by the aforesaid State Court action. The issue as to the validity of said mortgage was tried before the Referee on March 10, 1958.

The principal ground of objection by the trustee in bankruptcy to the validity of the chattel mortgage was that the purported description of property to be made subject to said mortgage was so inadequate as to fail totally to comply with the statutory requirements of the California Civil Code (Sec. 2956), and that it was impossible to determine with any particularity whatsoever what assets of the bankrupt corporation were subject to the chattel mortgage.

The evidence disclosed and the Referee found that the bankrupt corporation executed and delivered to L. E. McIntyre & Co. a note and chattel mortgage by means of an escrow handled by the Security-First National Bank of Los Angeles. The mortgage purported to cover assets of

the mortgagor described in the body of the subject mortgage only as: "Certain fixtures, machinery and tooling equipment, and located at 224 East Palmer Avenue, in the City of Compton, State of California." A notice of intended mortgage with respect to said mortgage of chattels was executed, recorded and published. The evidence further disclosed and the Referee found that an inventory list describing machinery and equipment of the mortgagor was deposited in said escrow, but that said inventory list was not attached to or made a part of the subject mortgage. An amendment to the escrow instructions prepared by L. E. McIntyre & Co. and the bankrupt corporation affirmatively directed the escrow holder not to attach a list of the inventory to the chattel mortgage being recorded.

The Referee found and concluded that the description as given on the mortgage in itself was self-sufficient [Tr. 59]. The Referee further found and concluded that if there was any insufficiency in description the exact description could be ascertained by following a line of inquiry suggested by information disclosed in the instrument itself [Tr. 17, 62], such "information" in this case being solely the address of the mortgagor.

On the petition for review, the District Court affirmed the Referee's decision and adopted in full the findings of fact, conclusions of law and order of the Referee [Tr. 28-30].

Specification of Errors.

The following are the errors upon which appellant intends to urge that the decision of the lower court be reversed:

1. The District Court erred in failing to reverse the Order of the Referee, dated May 27, 1958, and in affirming said Order.

2. The District Court erred in ratifying, confirming, and approving the Findings of Fact and Conclusions of Law, and Order re Chattel Mortgage, dated May 27, 1958, of the Referee, and in adopting the same in full as the Findings of Fact, Conclusions of Law and Order of the District Court.

3. The District Court erred in respect to said Order, in that the Finding of Fact No. 6 (of the Referee and the District Court) is clearly erroneous in that said Finding 6 actually constitutes a conclusion, which conclusion is not supported by the evidence adduced at the hearing on said matter.

4. The District Court erred in respect to said Order in that the Findings of Fact (of the Referee and of the District Court) fail and omit to include a finding as to which of the items of fixtures, machinery and tooling equipment, which were sold by Ralph Meyer as assignee for the benefit of creditors, were covered by the subject chattel mortgage.

5. The District Court erred in respect to said Order, in that the Conclusion of Law No. 2 (of the Referee and of the District Court) is clearly erroneous, concluding that the subject mortgage was valid and enforceable against creditors, this estate and the trustee in bankruptcy herein.

6. The District Court erred in respect to said Order, in that the Conclusions of Law Nos. 3 and 4 (of the Referee and of the District Court) are clearly erroneous, each being based upon the erroneous conclusion that the subject chattel mortgage is valid and enforceable.

Summary of Argument.

I.

THE REFEREE'S FINDING OF FACT THAT THE DESCRIPTION OF PROPERTY CONTAINED IN THE MORTGAGE WAS SUFFICIENT SHOULD NOT HAVE BEEN SUSTAINED IN THAT THERE WAS NO SUBSTANTIAL EVIDENCE TO SUPPORT IT. THE DESIGNATION AS "FINDINGS OF FACT" OF WHAT IN REALITY ARE CONCLUSIONS OF LAW WILL NOT OPERATE TO LIMIT THE REVIEWING POWER OF THE HIGHER COURT.

II.

TO BE SUFFICIENT AGAINST A THIRD PERSON, AND THUS AGAINST APPELLANT TRUSTEE IN BANKRUPTCY, A DESCRIPTION OF THE MORTGAGED PROPERTY MUST POINT OUT THE SUBJECT MATTER WITH PARTICULARITY SO THAT THIRD PERSONS MAY BE ABLE TO IDENTIFY THE CHATTELS COVERED.

(a) THE "DESCRIPTION" OF THE MORTGAGED PROPERTY, AS IT APPEARS ON THE FACE OF THE SUBJECT MORTGAGE AND UNAIDED BY OUTSIDE INFORMATION, FAILS ADEQUATELY TO DESCRIBE THE PROPERTY INTENDED TO BE MADE SUBJECT THERETO. IT WAS ERROR TO INTERPRET THE WORD "CERTAIN" AS MEANING "ALL".

(b) THE LANGUAGE OF THE CHATTEL MORTGAGE ITSELF TOTALLY FAILS TO SUGGEST A LINE OF INQUIRY, WHICH IF PURSUED WOULD IDENTIFY THE PROPERTY TO BE COVERED BY THE MORTGAGE.

(c) NEITHER THE ESCROW NOR THE INVENTORY LIST WERE REFERRED TO IN THE MORTGAGE, AND IT WAS ERROR TO ADMIT INTO EVIDENCE OVER APPELLANT'S OBJECTION THE LIST OF MACHINERY AND EQUIPMENT WHICH THE PARTIES HAD PLACED INTO ESCROW AND AFFIRMATIVELY WITHHELD FROM THE MORTGAGE AND FROM RECORDATION.

ARGUMENT.

I.

The Referee's Finding of Fact That the Description of Property Contained in the Mortgage Was Sufficient Should Not Have Been Sustained in That There Was No Substantial Evidence to Support It. The Designation as "Findings of Fact" of What in Reality Are Conclusions of Law Will Not Operate to Limit the Reviewing Power of the Higher Court.

Appellant has no quarrel with the well-settled rule that the District Court should accept the Referee's findings of fact unless such findings are clearly erroneous. However, the corollary to that rule is that if there is no substantial evidence to support it, the Referee's findings will not be sustained.

In re Collins (S. D. Calif.), 141 Fed. Supp. 25.

It is equally clear that the designation as "Findings of Fact" of what in reality are conclusions of law will not operated to limit the reviewing power of the higher court.

The issue at the trial and upon this appeal is whether the language in the subject mortgage adequately describes the property to be mortgaged.

In the instant case, the Referee was not presented with any problems of contradictory witnesses or substantially conflicting testimony or evidence. The Referee did not have to weigh the credibility of one witness against the credibility of another. There are no substantial factual conflicts in the evidence presented to the Court.

The issue herein arises upon the inferences and conclusions reached by the Referee from the evidence. Such inferences and conclusions are not conclusive upon the reviewing court; just as in other situations, the trier of fact should resolve disputed issues of fact, but questions of policy and statutory interpretation are ultimately for the Appellate Courts to determine.

The question of whether the description of property in a chattel mortgage is legally adequate, as required by California Civil Code, Section 2956, is a question of statutory interpretation—not a disputed issue of fact, but truly a question of law subject to review by the Appellate Courts.

Furthermore, as the California Supreme Court stated in *Kahriman v. Jones*, 203 Cal. 254, 263 Pac. 537:

“The provisions of the Civil Code relating to chattel mortgages have been strictly construed by the courts, as indeed, they should be, for those sections give a special right to a lien independent of possession, a situation unknown to the common law with relation to personal property.”

For the same effect is the case of *Hopper v. Keys*, 152 Cal. 493, 92 Pac. 1017, in which it was said:

“It must be conceded that the authority for the creation of chattel mortgages in this state derives its force from the statutory provisions relating to the subject, and that all rights accruing by virtue of such mortgages can be protected and preserved only by fully meeting the requirements of the statute and strictly observing its provisions.” (At 92 Pac. 1019, 1020.)

The Referee conceded that his responsibility was one of statutory interpretation [Tr. 59, 60]. His error did not relate to resolving a dispute as to facts, but in interpreting the legislative requirement. More specifically, the Referee erred in allowing a “hard case” to result in bad law—in turning a “doubt” as to what the mortgage meant into a “doubt [that] must be resolved in favor of the one who has the equitable side of the case, which in this case is the mortgagee.” [Referee’s remarks in ruling from the bench, Tr. 60.] This statement of the Referee is even in direct conflict with the Referee’s statement made immediately prior thereto to the effect that the instant case was simply a question of law—“purely upon the technicality of a statute. And, so, it is not a case which calls for the exercise of any equitable jurisdiction that the Court may have; . . . [Tr. 59].

The actual evidence which was presented before the Referee will be reviewed in the arguments to follow.

II.

To Be Sufficient Against a Third Person, and Thus Against Appellant Trustee in Bankruptcy, a Description of the Mortgaged Property Must Point Out the Subject Matter With Particularity so That Third Persons May Be Able to Identify the Chattels Covered.

- (a) The “Description” of the Mortgaged Property, as It Appears on the Face of the Subject Mortgage and Unaided by Outside Information, Fails Adequately to Describe the Property Intended to Be Made Subject Thereto. It Was Error to Interpret the Word “Certain” as Meaning “All.”
- (b) The Language of the Chattel Mortgage Itself Totally Fails to Suggest a Line of Inquiry, Which if Pursued Would Identify the Property to Be Covered by the Mortgage.
- (c) Neither the Escrow nor the Inventory List Were Referred to in the Mortgage, and It Was Error to Admit Into Evidence Over Appellant’s Objection the List of Machinery and Equipment Which the Parties Had Placed Into Escrow and Affirmatively Withheld From the Mortgage and From Recordation.

The bankrupt had been engaged in the machine shop business in the City of Compton and owned a very substantial amount of machinery, equipment and fixtures. Appellees’ claim is based upon a mortgage bearing date of May 25, 1956, a copy of which chattel mortgage is attached as an exhibit to said mortgagee’s original petition herein. The subject chattel mortgage was prepared upon a printed form with certain information filled in by

typewriting, plus signatures thereon. The description of the mortgaged property is set forth in the subject mortgage as follows:

“WITNESSETH: THAT THE MORTGAGOR MORTGAGES TO THE MORTGAGEE ALL THAT CERTAIN PERSONAL PROPERTY SITUATED AND DESCRIBED AS FOLLOWS, TO WIT: *Certain fixtures, machinery and tooling equipment, and located at 224 East Palmer Avenue, in the City of Compton, State of California.*”

The capitalized portion above represents printed portion of the mortgage, and the italicized portion above represents words typed in. The above is the entire description of the property to be subject to said mortgage.

In Section 2956 of the California Civil Code appears the form in which chattel mortgages may be made. It is simple and short:

“This mortgage, made the..... day of in the year, by A B, of, mortgagor, to C D, of, mortgagee, witnesseth:

That the mortgagor mortgages to the mortgagee (here describe the property), as security for the payment to him of dollars, on (or before) the day of in the year, (or, as security for the payment of a note or obligation, describing it, etc.) A B.”

The California courts have been loath to enforce a mortgage or to declare it valid where there has been an omnibus or roving description, on the basis that such description is too indefinite, general and uncertain to furnish, through constructive notice thereof, the means of identification, and therefore furnishes neither guide

nor protection to either purchaser or seller concerning specific chattels.

A further distinction emphasized by the courts concerns itself with whether the controversy is between the parties or involves a third person. As between the parties, a description of the property mortgaged is sufficient if it so identifies the chattel that the mortgagee may say with reasonable certainty what is subject to his lien, but as stated in 10 Am. Jur. 752, §55:

“To be sufficient against a third person, the description of the mortgaged property must be definite enough to enable him, aided by inquiries which the instrument itself suggests, to identify the property. A description which may be amply sufficient as between the immediate parties to a mortgage will, in many cases, not be sufficient as against creditors of, or purchasers from, the mortgagor.”

Appellant, as trustee in bankruptcy, stands in the position of a third party creditor.

Section 70c of the Bankruptcy Act (11 U. S. C. §110c) provides in part:

“The trustee, as to all property . . . upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date with all the rights, remedies, and power of a creditor then holding a lien thereon by such proceedings.”

The attempted description of personal property in the subject chattel mortgage is an inadequate description under California law, and said mortgage by virtue of such insufficient, uncertain and indefinite description is

invalid as against third parties, including the trustee in bankruptcy.

The United States District Court for the Southern District of California has twice had the occasion, in the past several years, to examine into and rule upon questions similar to that presented in the instant case. The first of said two cases was *In re Kessler*, 90 Fed. Supp. 1012 (1950). Here the Court (Mathes, D. J.) held that the chattel mortgage was invalid because of an unreasonable delay in recordation and:

“Furthermore the description in the mortgage of the chattels intended to be covered is insufficient for identification.”

In this case, the chattel mortgage executed by the bankrupt described a cash register, soda fountain, and other equipment, gave the mortgagor's occupation as “Kessler's Pharmacy” and gave the location of the mortgaged property as “Burbank, California.” The District Court cited as leading California cases on the question of adequate description of property in a chattel mortgage the following:

Pace v. Threewit, 31 Cal. App. 2d 509, 88 P. 2d 247 (1939) and

Pacific States Savings & Loan Co. v. Hoffman, 134 Cal. App. 604, 25 P. 2d 1007.

In 1954 Judge Mathes again considered the problem in the case of *In re Driscoll*, 127 Fed. Supp. 81. In the latter case, the chattel mortgage of the bankrupt restaurant operator specifically listed a number of items of restaurant equipment, in many instances with the serial numbers, model numbers, manufacturers' names, dimensions, colors and materials of which constructed. The

fourth item, for example, is described as: "One multiple malt mixer with dispenser model number 9 B 3, Serial Number 33907." No location other than "County of Los Angeles" was stated in the mortgage. Judge Mathes held that where the property had been described in sufficient detail so as to enable it to be found and identified on inquiry, the failure to give the address where the property was located did not destroy the validity of the mortgage. Judge Mathes referred to his decision in the *Kessler* case *supra*, stating that the ground of invalidation in the latter case was the unreasonable delay in recordation and that his comments about the insufficiency of description were *obiter dictum*.

While the main issue in the *Driscoll* case was the significance of the absence of an address in the mortgage, the Court seriously discussed and reviewed California law generally on the question of sufficiency of description, and the opinion of Judge Mathes states:

"The rule as stated by the California Courts governs here: 'To be sufficient against a third person, the description of the mortgaged property must be definite enough to enable him, aided by inquiries which the instrument itself suggests, to identify the property.' "

The Court cited:

Pace v. Threewit, *supra*, 31 Cal. App. 2d at p. 510, 88 P. 2d at p. 248;

Pacific National Agricultural Credit Corporation v. Wilbur (*supra*), 2 Cal. 2d at p. 589, 42 P. 2d at p. 320;

United Bank & Trust Co. v. Powers, supra, 89 Cal. App. 690, 265 Pac. 403;

John Breuner Co. v. King, supra, 9 Cal. App. at p. 273, 98 Pac. at p. 1078;

Cf.

Osborn v. Wells (6 Cir., 1934), 69 F. 2d 970.

Here again Judge Mathes ruled in favor of specificity as compared with generality in description.

In *Pace v. Threewit*, 31 Cal. App. 2d page 510, 88 P. 2d page 248, the Court turned once again to the general rules set forth in 10 Am. Jur. page 752, Section 55:

“Third parties are under no obligation to exhaust every possible means of information before they can safely proceed to treat the property of the mortgagor as unencumbered. The record of a mortgage is not constructive notice to them where it does not describe any particular property or furnish any data which will direct the attention of those reading it to some source of information beyond the words of the parties to it. In nearly all cases, however resort must be had to other evidence than that furnished by the mortgage itself to enable third persons to identify mortgaged property, and generally where there is a description of the property mortgaged and the description is true and by the aid of such description and the surrounding circumstances the third person would in the ordinary course of things know the property that was mortgaged, the description will be held to be sufficient.”

After stating the general rule, the Court turned its attention to the earlier case of *Pacific National Agri-*

cultural Credit Corporation v. Wilbur, 2 Cal. 2d 576, 42 P. 2d 314, and observed that the Court in the earlier case had quoted the rule from 11 C. J. 457:

“As against third persons the description in the mortgage must point out the subject-matter so that such persons may identify the chattels covered, but it is not essential that the description be so specific that the property may be identified by it alone, if such description suggests inquiries or means of identification which, if pursued, will disclose the property covered. This rule is based upon the maxim, that is certain, which is capable of being made certain. So a description is sufficient if it may be aided by parol proof and the property covered by the mortgage identified.”

Pace v. Threewit observes in connection with the above-quoted rule that:

“It is a well-settled rule that parol evidence may aid but not make a description.” (Emphasis added.)

The Court goes on further in the *Pace v. Threewit* decision to place special emphasis on the rule that parol evidence may aid but not make a description, stating:

“It is pointed out in the rules above set forth that the description should be such that the property may be identified by it alone or that the description in itself should suggest inquiries or means of identification which, if pursued, will identify the property. But, as pointed out in some of these cases, the suggestion of a line of inquiry must appear in the mortgage itself and not rest solely in the mind of the mortgagee or mortgagee.”

The most recent case reported in California on sufficiency of description of a chattel mortgage is *Witt v. Milton*, 305 P. 2d 944, D. C. A. First Dist. Div. 1 Calif., January 14, 1957. Here again the Court indicated that a chattel mortgage which did not adequately describe what was being mortgaged so that it could be easily identified was void as to third parties. The Court stated in its decision:

“Plaintiff has cited and we have found no case where extrinsic evidence has been admitted to identify the chattels mortgaged unless there is something in the description or in the mortgage itself which suggests inquiries or means of identification. Apparently it is plaintiff’s theory that without any specific clue to identification in the mortgage, he would be permitted to prove where, as a matter of fact, the property was located, the mortgagor lived, and the manner in which and from where defendants acquired the property. This theory violates the rules set forth in the above mentioned cases. As said in *Pace v. Threewit*, *supra*, 31 Cal. App. 2d 509, 512, 88 P. 2d 247, 248, quoting from Cobbey on Chattel Mortgages, Section 170, it must be “A description which will enable third persons to identify the property, aided by inquiries which *the mortgage itself indicates and directs* * * *.” (Emphasis added.) Again the court quoted from *Ehrke v. Tucker*, 99 Kan. 52, 160 P. 985, “* * * the suggestions which indicate the line of inquiry must be taken from the mortgage itself and not rest alone in the mind of the mortgagor or mortgagee.”

Thus, it appears that it is impossible from the mere listing of the articles in the mortgage to de-

termine their identity, and hence under the authorities, the mortgage is void as to third parties, and hence as to defendants.”

Applying the above law to the case at hand, it is clear that it was error to admit the inventory list into evidence and to rely upon the inventory list as providing the necessary description of the mortgaged articles. Nothing in the instrument itself suggests the existence of such inventory list or an inquiry which would lead to such list. The Referee based this portion of his ruling *solely* upon the fact that the instrument contained the address of the mortgagor. The Referee, in his ruling from the bench, stated as follows:

“An inquiry at that address would have led to the escrow, and the escrow had the detailed description of the mortgaged property in its file, and that description is identified in the supplemental escrow instructions. This exhibit ‘McIntyre’s No. 3’ is captioned ‘Inventory,’ and the inventory is referred to in the supplemental instructions, so that you have the whole thing.”

In other words, says the Referee (and so also the District Court below), any time the parties include an address in the mortgage instrument, it is no longer necessary to give *any* description of the property being made subject to the chattel mortgage, because any interested third person may go to that address, knock on the door and inquire as to what the parties intended to be covered by their recorded mortgage. This, it is submitted, is not at all the law of California.

While appellant does not concede that a mere reference to the inventory list in the body of the instrument

would be sufficient to put third parties on notice of the contents of such list (*In re Mineral Lac Paint Co.*, 17 Fed. Supp. 1, discussed *infra*), the total absence in the instrument of any suggestion of such a list makes evident the error of admitting such list into evidence. And without such list, we have no description of any kind.

Without aid of outside information, the “description” appearing on the face of the subject mortgage fails adequately to describe the property intended to be made subject thereto. It was error to interpret the word “certain” as meaning “all.”

The Referee held that “The description as given on the mortgage itself [in] itself is self-sufficient” [Tr. 59]. As to this portion of his holding, the Referee is saying that the language appearing on the face of the mortgage, unaided by outside information, is sufficient to inform (and charge) third persons as to the items of personal property made subject to the mortgage. To do this, the Referee had to, and did, conclude that the word “certain” as used in “Certain fixtures, machinery and tooling equipment . . .” meant, “all,” and did not mean “some” or “a portion of.” [Tr. 59, 60]. As a matter of fact, the Referee first translates this particular “certain” to mean “the,” and then by implication reads the newly provided description “*the* fixtures, machinery and tooling equipment . . .” as meaning *all* fixtures, machinery and tooling equipment of the bankrupt corporation. With the sincerest of respect for the Referee, it is submitted that such license with words is more appropriate for poetry than logic in the law.

The Referee conceded [Tr. 60] that if the word “some” or the word “part” had been used in the place of “certain” his ruling would have to be different.

Appellant submits that there is substantial authority that the word "certain" is not the equivalent of "all," but is rather the equivalent of "some among possible others."

As stated in Black's Law Dictionary (4th Ed.) 1951, under the heading "CERTAIN," this word includes among other definitions the following:

"Some among possible others, *in re Mineral Lac Paint Co.*, D. C. Pa. 17 Fed. Supp. 1, 2."

The *Mineral Lac Paint Co.* case presented precisely the question with which this appeal is concerned. It involved the objection by a trustee in bankruptcy to the validity of a conditional sale contract (presented as the basis of a reclamation petition) upon the basis that such contract failed adequately to describe the machinery and equipment sold. The subject conditional sale contract referred to "certain machinery, apparatus, plant and equipment now upon premises 3306-16 E. Thompson Street, Philadelphia, Pennsylvania, described in a schedule hereby annexed, made a part hereof and referred to as Exhibit 'A'." However, no schedule of machinery and equipment was actually annexed to or filed with the conditional sale contract.

The District Court held that the document was incomplete without a more definite and specific description of the machinery and equipment and denied the reclamation petition. The Court stated (at page 2):

"We think that the word 'certain,' used in referring to the machinery and equipment in the part of the contract which we have quoted, followed as it is stated to be by a detailed description (which was not in fact attached), was used in the sense of 'some

among possible others.' Webster's New International Dictionary of the English Language (2d Ed.) Unabridged, p. 440, definition 2b. As so interpreted the language referring to the machinery and equipment in the contract is too indefinite to constitute a sufficient reference to support the agreement."

The law of the *Mineral Lac* case was reaffirmed and followed in the matter of *In re Smith*, also District Court Pennsylvania, 19 Fed. Supp. 597. This case also involved a sufficiency of description as machinery and equipment that was the subject matter of conditional sale agreements (subject, in Pennsylvania, to the requirements of the Uniform Conditional Sales Act). In the *Smith* case, the Court conceded that parol evidence is admissible to identify property which is the subject of such a contract, but held the contracts invalid, stating:

"It is we think equally clear that the contract must itself definitely indicate identifiable goods as having been sold and must itself suggest the inquiries by means of which if pursued the goods may be further identified."

All parties have recognized that the subject instrument must itself, within its four corners, suggest the inquiries by means which, if pursued, the personal property may be further identified. The fact that the *Mineral Lac* contract referred to a schedule of machinery and equipment which in fact was not attached, makes the *Mineral Lac* case even stronger in support of appellant's position. The reference to a schedule or an exhibit (not attached) might be considered as suggesting an inquiry. The total absence of any reference to any schedule or exhibit hardly suggests inquiry.

Additionally, it is submitted that it is the reasonable inference from the evidence that it was never the intention of the draftsman of the subject instrument that the mere words "certain fixtures, machinery and tooling equipment" be considered as either the intended or proper description of the items to be covered by the mortgage, but rather that the escrow officer or whoever typed the words onto the mortgage form fully expected to attach to said mortgage the detailed list of machinery and equipment of the mortgagor, which list, if so attached, would have supplied the necessary description.

Conclusion.

Relating the rules enunciated above, governing the degree of definiteness of description of mortgaged chattel, it is most evident that the chattel mortgage of appellees clearly fails to specify the very minimum requirements of description of mortgaged chattels. "Certain fixtures, machinery and tooling equipment" of the bankrupt were purportedly mortgaged by the subject instrument. Such description, by itself, is not sufficient or adequate. No further description or list is provided an interested creditor. Nothing in this description suggests a line of inquiry which if pursued would enable an interested third person to determine what personal property of the mortgagor was involved. Nothing in the body of the subject mortgage assist an intelligent inquirer in finding out what the mortgagor and the mortgagee had in mind. Any assistance which could have been provided was frustrated by the affirmative directions given by both parties to the escrow holder not to attach the list of inventory to the chattel mortgage at the time of recordation. This direction was in direct contravention to the

purpose of the statute and resulted in a completely inadequate legal description being recorded.

Upon all of the grounds herein presented, the order of the Referee and the Order of the District Court Affirming the Order of the Referee should be reversed, with instructions to the Court below to enter judgment for appellant trustee in bankruptcy, declaring the subject chattel mortgage to be invalid and that appellees have no lien upon any of the assets of the subject bankrupt estate.

Respectfully submitted,

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No. 16515

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

A. J. BUMB, Trustee in Bankruptcy of the Estate of
Ampco Products of California, Inc., Bankrupt,

Appellant,

vs.

L. E. McINTYRE and M. H. McINTYRE, doing business
as L. E. McIntyre & Co.,

Respondents.

RESPONDENTS' ANSWERING BRIEF.

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FILED

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No. 16515

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

A. J. BUMB, Trustee in Bankruptcy of the Estate of
Ampco Products of California, Inc., Bankrupt,
Appellant,

vs.

L. E. McINTYRE and M. H. McINTYRE, doing business
as L. E. McIntyre & Co.,
Respondents.

RESPONDENTS' ANSWERING BRIEF.

Statement of the Case.

The respondents on appeal are L. E. McIntyre and M. H. McIntyre, doing business as L. E. McIntyre & Company. L. E. McIntyre & Company claims the position of a secured creditor of the bankrupt estate of Ampco Products of California, Inc. by reason of a valid chattel mortgage executed prior to bankruptcy. The undisputed facts are that on May 25, 1956 Ampco Products of California, Inc. executed a chattel mortgage to L. E. McIntyre & Company which was duly published and recorded in all respects. Subsequently on August 13, 1957, Ampco Products of California, Inc. made a general assignment for the benefit of creditors to Ralph Meyer. The assignee then sold all the assets of the bankrupt corporation to a third party for \$28,775.00. An involuntary Petition in Bankruptcy was filed on October 28, 1957. An

Order of Adjudication was entered and the assignee paid over all funds in his possession to the trustee in bankruptcy. Repondents filed a petition for an order to show cause requiring the trustee to show cause why he should not be substituted as a party defendant instead of the bankrupt. The trustee filed his answer and counter-claimed that the mortgage was unenforceable as against him on the principal ground that the description of the property mentioned in the mortgage was legally inadequate. The issue as to the validity of the chattel mortgage was tried before the Referee in Bankruptcy on March 10, 1958. The respondents' evidence showed, and the Referee found, the following facts:

1. That for valuable consideration the bankrupt corporation executed and delivered to L. E. McIntyre & Company a note and chattel mortgage by means of an escrow accomplished at the Security-First National Bank of Los Angeles.

2. That a Notice of Intended Mortgage with respect to said mortgage was duly executed, recorded and published.

3. That an inventory list of all the specific items of personal property covered by the executed mortgage had been deposited in said escrow file along with the executed mortgage. However, the inventory list was not actually attached to said mortgage.

4. That the words used in the chattel mortgage to describe the property mortgaged were sufficiently definite and certain to satisfy California law. The Referee held “. . . the description as given on the mortgage [is in itself] self sufficient,” [Tr. p. 59] and “If there is any insufficiency of description, the exact description can be ascertained by information disclosed in the instrument itself.” [Tr. p. 62.]

Appellant petitioned the United States District Court for review of the Referee's decision upholding respondents' position as a secured creditor. Appellant's primary ground for contesting the Referee's Ruling was that the Referee had not correctly applied California law. The briefs filed in the District Court contained an exhaustive compilation of the California statutory and case authority on the question whether respondents' chattel mortgage contained a sufficient description of the property mortgaged to satisfy California law. The District Court found that respondents' chattel mortgage was valid in all respects and affirmed the Referee's decision and adopted in full the findings of fact, conclusions of law and order of the Referee. [Tr. 28-30.] The appellant has appealed this decision of the District Court. Respondents urge that the District Court's decision was correct in all respects and therefore should be affirmed.

Issues on Review.

The question before the District Court was the correctness of the Referee's Ruling that the description in the chattel mortgage executed by the bankrupt was sufficient to bind the Trustee under California law. The District Court upheld the Referee's decision in all respects and adopted the Referee's findings of fact, conclusions of law and order as its own. Therefore the only issues before this appellate court are (1) were the Referee's findings of fact supported by any substantial evidence, and (2) did the Referee and the United States District Court correctly apply California law.

ARGUMENTS AND LAW.

POINT I.

There Was Substantial Evidence to Support the Finding by the Referee That the Description of Property Contained in the Mortgage Satisfied California Law.

The findings of fact of the Referee must be accepted unless they are clearly erroneous. Therefore, if there is any substantial evidence to support the Referee's findings, said findings must be affirmed. *In Re Collins* (S. D. Calif. 1956), 141 Fed. Supp. 25.

Appellant objects to all of the Referee's findings of fact in his Specification of Errors No. 2 on page 5 of his brief. However, with the exception of Finding No. 6, the Referee's findings of fact contain matter which has been either stipulated to by the parties or admitted to be correct by appellant himself either in his statement of the facts or elsewhere in his brief. Therefore, it will be assumed that the only finding of fact to which the appellant really objects is Finding number 6 which states: "The description of the property contained in the said Mortgage of Chattels, as recorded, is sufficiently definite and certain to enable third parties, aided by inquiries which the instrument itself suggests, to identify the property covered thereby." [Tr. p. 17.] From reading the Reporter's Transcript it is clear that there was substantial and uncontradicted evidence to support said finding. A copy of the mortgage instrument itself was offered in evidence and from it a creditor could determine the exact location of the chattels mortgaged [Tr. p. 59], the name and address of the mortgagor and its officers [Tr. p. 62] and the name of the mortgagee and its address. Further, there was much evidence produced which showed that an

escrow had been set up at a certain branch of the Security-First National Bank of Los Angeles to handle the transaction between respondent and the bankrupt and that a notice to this effect had been properly published. Further evidence was introduced that a complete list of all the chattels mortgaged was included in and made a part of the escrow file in said bank. The Referee based his findings on all the above evidence in ruling:

“You have a very definite address—‘224 East Palmer Avenue, in the City of Compton, State of State of California.’ An inquiry at that address would have led to the escrow, and the escrow had the detailed description of the mortgaged property in its file, and that description is identified in the supplemental escrow instructions. This exhibit ‘McIntyre’s No. 3’ is captioned ‘Inventory,’ and the inventory is referred to in the supplemental instructions, so that you have the whole thing. I say I go along as far as counsel goes, but I go farther. On behalf of the mortgagor the mortgage was executed by its president and its vice president, and inquiry at the address given would have led to one or the other or both of these men, who again, could have said, ‘There is an escrow and in that escrow you will find the detailed description.’” [Tr. p. 62.]

It is therefore clear that there was substantial evidence to support the Referee’s finding that a reasonable creditor, aided by inquiries which the chattel mortgage instrument itself suggested, would be able to identify the property covered by the mortgage and said finding should therefore be affirmed.

POINT II.

Finding of Fact Number 6 Is a Proper Finding of Fact in All Respects.

Appellant, on page 7 of his brief, claims that finding of fact number 6 is actually a conclusion of law. This contention is without merit. Findings of fact are necessarily findings of ultimate facts. The ultimate fact involved here is whether there was sufficient information in the mortgage instrument to make it possible for a reasonable creditor upon inquiry at sources suggested by the instrument to determine the chattels which were subject to the mortgage. A conclusion of law, on the other hand, is based on the finding of an ultimate fact and is the legal conclusion reached as a result of said finding, *e.g.*, that because a reasonable creditor could determine the property mortgaged from sources of information suggested in the instrument, therefore the chattel mortgage is enforceable under California law as against the trustee in bankruptcy. [See Concl. of Law No. 2, Tr. p. 18 for said conclusion of law resulting from Finding of Fact No. 6.] Since Finding number 6 does not contain a statement relating to the legal effect of the ultimate facts found therein, it is not in reality a conclusion of law as appellant contends, but is a proper finding of fact.

Levins v. Rovegno, 71 Cal. 273 (1886); Witkin, *California Procedure*, Vol. 2, p. 1843.

POINT III.

Since by "Describing the Property" the Mortgage Instrument Did Substantially Comply With the Requirements of Civil Code, Section 2956, Any Doubt as to the Technical Requirements of This Statute Should Be Resolved in Favor of the Party Which Has the Equities on His Side.

On page 8 of Appellant's Brief, *Kahriman v. Jones*, 203 Cal. 254 (1928), is cited for the proposition that the provisions of the Civil Code, Section 2956, *et seq.*, relating to chattel mortgages, should be "strictly construed." Respondents urge that this statement in *Kahriman v. Jones* should be limited to the facts before that court. Civil Code, Section 2956 sets forth certain minimum requirements for a valid mortgage: it must be clearly entitled, it must contain the names of the parties, a description of the property mortgaged and, prior to 1935, the amount of money due and the date said money is due. *Kahriman v. Jones*, *supra*, was decided prior to 1935 and the due date was completely absent from the face of the mortgage instrument. The court held that since information required by the statute to be in the mortgage instrument was totally lacking, the statute should be "strictly construed" and the mortgage was therefore held invalid as against creditors. However, the mortgage instrument in the case at bar complied with all of the minimum requirements of Section 2956 including a description of the property. In such a case, any doubts about the technical requirements of the statute should be resolved in favor of the party with the

equities on his side. As the Referee and District Court held: where “a technical statute is involved such as we have here, and a proceeding such as we have here, the doubt must be resolved in favor of the one who has the equitable side of the case, which in this case is the mortgagee.” [Tr. p. 60.]

POINT IV.

The Equities Are on the Side of the Mortgagee in a Proceeding to Determine Whether the Mortgagee Shall Be Deprived of Security for Which He Gave Valuable Consideration.

In this case the equities are clearly on the side of the mortgagee, L. E. McIntyre & Company. L. E. McIntyre & Company gave valuable consideration for the promissory note and chattel mortgage of Ampsco Products of California, Inc. Respondents' company would not have entered into the agreement without security since Ampsco Products of California, Inc.'s financial condition was known to be insecure. The only way Ampsco Products of California, Inc. could therefore have obtained new capital was through a secured indebtedness. Where the mortgagee has clean hands and is completely fair in all the transactions related to said mortgage, and every effort is made to comply with California law, including proper publication of notice and recordation, there is a strong policy to allow respondents to enforce their secured position. Any grounds for denying respondents their secured position must be *more* substantial than the mere technicalities or tenuous arguments presented by appellant.

POINT V.

California Case Law Supports Respondents' Contention That the Description of Property in the Chattel Mortgage at Bar Was Fully Adequate.

The description in the chattel mortgage at bar was fully adequate under all California cases and statutory law. The only California statute dealing with the formal requirements of a chattel mortgage is Civil Code, Section 2956 which provides:

“A mortgage of personal property or crops shall be clearly entitled on the face thereof, apart from and preceding all other terms of the mortgage, to be a mortgage of crops and chattels, or either, and such mortgage may otherwise be made in substantially the following form:

This mortgage, made the day of, in the year, by A B, of....., mortgagor, to C D, of, mortgagee, witnesseth:

That the mortgagor mortgages to the mortgagee (here describe the property), as security for the the payment to him of dollars, on (or before) the day of, in the year, (or, as security for the payment of a note or obligation, describing it, etc.) A B.

No mortgage of personal property or crops shall be invalid for any purpose by reason of the omission to state therein the interest rate or the due date or due dates of the obligation or obligations secured thereby.”

The chattel mortgage in question is in the following form:

“MORTGAGES OF CHATTELS

This Mortgage, Made the 25th day of May, in the year 1956 By Ampsco Products of California, Inc. of Los Angeles County, State of California, Mortgagor, To L. E. McIntyre & Company, a Partnership of Los Angeles County, State of California, Mortgagee, WITNESSETH: The Mortgagor mortgages to the Mortgagee all that certain personal property situated and described as follows, to-wit: Certain fixtures, machinery and tooling equipment, and located at 224 East Palmer Avenue, in the City of Compton, State of California, as security for the payment to said mortgagee of the promissory note, and the interest thereon, executed by the mortgagor in favor of the mortgagee, dated May 25, 1956 for \$27,500.00 . . . [then there appeared ten paragraphs of further terms of this mortgage agreement]. . . . In Witness Whereof, the Mortgagor has executed this instrument.

Notarial Seal

AMPSCO PRODUCTS OF CALIFORNIA, INC.
By: /s/ H. W. AIKINS, President
By: /s/ JOHN E. BREDBECK, Vice Pres.
/s/ HARVEY AIKINS
/s/ MRS. HARVEY AIKINS

After recording mail to
L. E. McIntyre & Company
5132 Duarte Street
Los Angeles, California”

Note that every requirement of Section 2956 has been substantially complied with by the chattel mortgage at bar. However, appellant contends that the description of property in said chattel mortgage is not sufficient to satisfy California law. In determining the merit of appel-

lant's claim this court is required to look to California law. *In re Driscoll*, 127 Fed. Supp. 81 (1954). [In the *Driscoll* case it was held: "Whether and to what extent a mortgage of this kind is valid, is a local question, and the decision of the state court will be followed by this court in such a case."]

There are many cases decided under California law which deal with the question of the adequacy of descriptions in chattel mortgages. Since California law is clear, and since there is no case, new or old, which indicates that the description in the respondents' mortgage is in any way difficient, there will be no attempt in this brief to restate all of said cases and their holdings. Only those California cases which are most directly in point with our fact situation will be dealt with here.

Pacific National Agricultural Credit Corp. v. Wilbur, 2 Cal. 2d 576 (1935), states the California rule by quoting from 11 C. J. 457, as follows:

"As against third persons the description in the mortgage must point out the subject-matter so that such persons may identify the chattels covered, *but it is not essential that the description be so specific that the property may be identified by it alone, if such description suggests inquiries or means of identification which, if pursued, will disclose the property covered.* This rule is based upon the maxim, that is certain which is capable of being made certain. So a description is sufficient if it may be aided by parol proof and the property covered by the mortgage identified.' " (Emphasis added.)

In re Driscoll, *supra*, is the controlling Federal District Court case in this District, dealing with the sub-

ject of description. In that case, the chattel mortgage listed a number of items of restaurant equipment, in many instances with serial numbers, model numbers, manufacturers' names, dimensions, colors, and materials of which constructed. The Referee had held that the chattel mortgage was void as against the Trustee for the sole reason that it failed to state the location of the property referred to therein. The District Court reversed the Referee, and cited *Pacific National Agricultural Credit Corp. v. Wilbur*, *supra*, quoting therefrom, as follows:

“ ‘As against third persons the description in the mortgage must point out the subject-matter so that such persons may identify the chattels covered, but it is not essential that the description be so specific that the property may be identified by it alone, if such description suggests inquiries or means of identification which, if pursued, will disclose the property covered.’ ”

In *In re Driscoll*, the Court cited with approval *Pacific States Savings & Loan Co. v. Hoffman*, 134 Cal. App. 604 (1933) and *John Breuner Co. v. King*, 9 Cal. App. 271 (1908). The court then said:

“Inclusion of the address where the mortgaged property is located is for obvious reasons the better practice. Ordinarily ‘a statement as to the location of the chattels mortgaged is one of the most important elements in the description.’ . . .” (Emphasis added.)

In *John Breuner Co. v. King*, *supra*, the following description was held to be sufficient:

“ ‘All the furniture, upholstery, carpets, draperies, chinaware and other household goods of every kind,

located and contained in and about that certain building, in said City and County of San Francisco, known as the 'Haddon Hall Apartment House,' and also known as No. 951 Eddy Street, said building being situated on the lot on the south side of Eddy Street, 68 feet 9 inch front, 120 feet deep, and commencing 137½ feet easterly from the southeast corner of Gough and Eddy Streets.' "

The case *Pacific States Savings and Loan Company v. Hoffman, supra*, is squarely in point with the case at bar. The chattel mortgage described the property as "all that certain personal property situated and described as furniture and furnishings contained in the property situate on the northeast corner of Grace and Franklin avenues, Los Angeles, California."

Against the claim of a party not the mortgagor, who apparently was a third party without notice, the court held that the description was valid, quoting from 5 Cal. Jur., p. 54, as follows:

" 'It has been held that a description is sufficient if it is such as to enable third parties or inquirers to identify the property covered by it.' "

From the foregoing authorities, it is clear that the following principles of California Law apply in determining the sufficiency of a description in a chattel mortgage:

1. That there is no fixed rule as to what factors must be included in a description, except that it must be sufficient to enable third parties upon inquiry to identify the property covered;

2. In order for the mortgage to be valid, the description need not be so definite that the specific property may be identified by reference to the chat-

tel mortgage alone, provided that the chattel mortgage contains sufficient information to enable third parties upon inquiry to identify it;

3. However, the location of the property by street address, or other specific identification of location, is an important element in the description, and, if the description contains such location, a more specific designation of the property is not required. (*In re Driscoll, supra.*)

4. A chattel mortgage covering all of a certain type of property at a given street address, in a given city, is clearly sufficient to render the chattel mortgage valid as against third parties. (*Pacific States Savings and Loan Company v. Hoffman, supra.*)

It will be noted that in *In re Driscoll, supra*, the description did contain serial numbers, model numbers, manufacturers' names and descriptions in a number of instances, but it apparently did not state the location of the property by a street address. Nevertheless, the chattel mortgage was held valid. The court specifically recognized the California rule that the statement of the address where the mortgaged property is located is one of the most important elements of the description. This is a clear recognition of the soundness of *Pacific States Savings and Loan Company v. Hoffman, supra*, which held that a description covering all of that certain personal property situated and described as furniture and furnishings contained in the property situated at a specific address is a sufficient description.

Certainly, if the descriptions in the cases above cited were held to be sufficient to enable third parties or inquirers to identify the property covered by the chattel

mortgages, then the description in the case at bar was sufficient to enable such third parties to identify the property covered.

The evidence showed that the chattel mortgage was executed, recorded and delivered through an escrow at the Security-First National Bank of Los Angeles; that a Notice of Intended Mortgage was published and recorded through the escrow, as required by California law; and that the mortgagor and mortgagee initialled and deposited in the escrow a detailed inventory of the items of furniture and fixtures which were covered by the chattel mortgage. Clearly, any inquiry by third parties would have enabled them to identify the property. An inquiry of the mortgagee, or mortgagor or at the address stated in the description would undoubtedly have revealed a specific description of the property, or would have led to the escrow, which contained such specific description. A reference to the Notice of Intended Mortgage, as published and recorded, likewise would have led to the escrow. The Referee correctly ruled:

“You have a very definite address—‘224 East Palmer Avenue, in the City of Compton, State of California.’ An inquiry at that address would have led to the escrow, and the escrow had the detailed description of the mortgaged property in its file, . . . and the inventory is referred to in the supplemental escrow instructions, so that you have the whole thing.” [Tr. pp. 34-35.]

Therefore if the inquiry rule is followed, as required by all the California cases, and by the Federal District Court cases in this District, then the only possible result is that the chattel mortgage did contain sufficient information to comply with the rule.

POINT VI.

The Case of Witt v. Milton Adds Nothing to the Rules Already Stated.

On page 17 of his Brief Appellant cites "the most recent case . . . *Witt v. Milton*," 147 Cal. App. 2d 554 (1957). The case has nothing new to add. The description of the property in the mortgage instrument only listed "certain quantities of beds, bedding, furnishings and furniture." *No location or place of business was listed*. The court held correctly that such description was inadequate. However, in the case at bar the description states the street, address, city and state. In *In re Driscoll*, *supra*, held that inclusion of the address where the mortgaged property is located ". . . is one of the most important elements in the description." And further, "Significant, too, in reviewing California's statutory scheme for chattel mortgages, is the fact that the Code specifically provides with respect to mortgages of 'animate chattels' that the description shall be adequate if *inter alia* there be stated 'the place where the same will be ordinarily located while it is owned by the mortgagor.' C. C., section 2977." Therefore, the result in *Witt v. Milton*, *supra*, is easily distinguishable from our case. The fact that *Witt v. Milton*, *supra*, adds nothing new to the rules already set out further accentuates the fact that there is *no case*, old or new, which in any way indicates that the description in the McIntyre mortgage is in any way inadequate.

POINT VII.

The Issue Before the Trial Court Was the Sufficiency of a Description of Property Mortgaged. The Law in This State Holds Third Party Creditors Are Considered to Have "Notice" of All Information "Which They Could Have Acquired Through Reasonable Inquiry at Sources Suggested by the Instrument." Therefore, Where There Is Ample Evidence That Creditors Had "Notice" That There Was Information in an Escrow File Which Helped Complete the Description, the Contents of Said File, Including Inventory Lists, Are Admissible and Relevant Evidence.

Respondents urge that there is no merit in appellant's contention on page 18 of his brief that it was error for the Referee to admit the inventory lists in evidence because "Nothing in the instrument itself suggests the existence of such inventory list or an inquiry which would lead to such list." (App. Br. p. 18.) Appellant then erroneously contends that the sole ground for the Referee's allowing the inventory lists in evidence was the fact that the instrument contained the address of the mortgagor. (App. Br. p. 18.) If appellant would read the Referee's statements immediately following those quoted by appellant he would not have made such a claim. In actuality, the Referee ruled that the inventory lists were relevant because he found that the instrument itself contained the name and business address of the mortgagor, the name and address of the mortgagee, the location and general description of the chattels mortgaged, and the names and addresses of the president and vice president of the mortgagor and an inquiry at any of these places would have revealed the existence of the inventory list.

The Referee had in mind every one of these sources of information when he ruled in favor of admissibility of the inventory lists. [See Tr. p. 62-63.] Clearly the trustee in bankruptcy should be treated as having knowledge of the contents of the inventory lists since they contained information which could have been acquired through reasonable inquiry at sources suggested by the instrument. The inventory lists were therefore properly admitted in evidence.

POINT VIII.

The Preferred Definition of the Word "Certain" Is "Ascertained; Precise; Definitive; . . . or, in Law, Capable of Being Identified or Made Known, Without Liability to Mistake or Ambiguity, From Data Already Given," and This Definition Should Be Used in This Case.

Appellant makes some point about the use of the word "Certain" in the property description on page 19 of his brief. He cites two cases based on Pennsylvania Law which were decided more than twenty years ago, and which are distinguishable on their facts, as his authority that the use of the term "certain" somehow makes the description indefinite. Respondents will first discuss and distinguish the cases relied on by appellant, *In Re Mineral Lac Paint Co.* (D. C., E. D. Pa. 1936), 17 Fed. Supp. 1, and *In Re Smith* (D. C., E. D. Pa., 1937), 19 Fed. Supp. 597, and then discuss the California cases and preferred dictionary definitions, all of which support respondents' position.

In the *Smith* case the conditional sales contract contained a description which was "little more than a jumble of words and figures." *In Re Smith, supra*, at p. 598. The

contract also referred to an attached copy of the description of the property sold but no description was attached. The court therefore held the description inadequate. The *Smith* case did not discuss the meaning of the word "certain."

In the *Mineral Lac* case, the conditional sales contract contained the following description:

" . . . certain machinery, apparatus, plant and equipment now upon premises 3306-16 E. Thompson Street, Philadelphia, Pennsylvania, described in a schedule hereto annexed, made part hereof, and referred to as Exhibit 'A'."

The schedule referred to as Exhibit "A" was not annexed to the conditional sales contract as filed of record. To the extent that the decision invalidated the conditional sales contract as against the Trustee in Bankruptcy because of a faulty description (there were other additional reasons for the conclusion reached), it resulted from the incompleteness of the conditional sales contract because of failure to attach the schedule. The Court went on, however, to point out that:

" . . . its [the schedules] omission is not cured by the brief general reference to the machinery and equipment sold contained in the portion of the contract above quoted, since that language is not sufficiently precise or definite, *particularly in view of the testimony that other similar machinery and equipment was located upon the premises mentioned*. We think that the word 'certain,' used in referring to the machinery and equipment in the part of the contract which we have quoted, followed as it is stated to be by a detailed description (which was not in fact attached), was used in the sense of 'some among pos-

sible others.' Webster's New International Dictionary of the English Language (2nd Ed.) Unabridged, p. 440, definition 2b . . . Regardless of this, however, the failure to include a schedule containing a description of the machinery and equipment sold, which schedule the contract itself expressly stipulates to be a part of it, in our opinion amounts to the omission of a material part of the contract" (Emphasis added.)

In the case at bar, the Chattel Mortgage does not refer to an exhibit or schedule attached, which, in fact, was not attached. Therefore, the *Smith* and *Mineral Lac* cases are distinguishable on their facts in that regard.

Further, there is no testimony, or other evidence, whatsoever in the case at bar that similar machinery and equipment were located on the premises other than that covered by the Chattel Mortgage, whereas, from the above quoted portion of the opinion, there was such in the *Mineral Lac* case. In this respect, also, the cases are distinguishable upon the facts. It obviously was *only* because of the evidence showing the existence of similar property not covered by the conditional sales contract that the Court in *Mineral Lac* adopted the definition of "certain" from Webster reading "some among possible others." The Court specifically said so.

Actually, the definition of the word "certain" from Webster's New International Dictionary (2d Ed.) Unabridged, 1948, reads as follows:

"1.a Fixed or stated; settled; determinate.

"b Precise; exact;

"2.a Implied or thought of as specific though not named."

Then comes definition 2.b, referred to in the *Mineral Lac* case and relied upon by the Trustee herein:

“2.b One or some among possible others; one or some known only as of a specified name or character; as, *certain* leaders of the people;—often used derogatorily; as, a *certain* Mr. Washington was elected President.”

Had the conditional sales contract not referred to a schedule attached, and had there been no testimony concerning the existence of similar machinery on the premises, the obviously preferred definition of “certain,” *i.e.*, “fixed or stated; settled; determinate,” would have prevailed.

It is to be noted, further, that, in the *Mineral Lac* case the description was not “all that certain property,” but was merely “certain property.” In the case at bar, the language was “all that certain personal property situated and described as follows, to-wit: Certain fixtures, machinery and tooling equipment, and located at 224 East Palmer Avenue, in the City of Compton, State of California.”

If the preferred definition of “certain” is used, then the description in the Chattel Mortgage in the case at bar reads: “*All that fixed, stated, settled, and determinate personal property situated and described as follows, to-wit: Fixed, stated, settled and determinate fixtures, machinery, and tooling equipment, and located at 224 East Palmer Avenue, in the City of Compton, State of California.*” This would advise anyone searching the records that by inquiry the precise items of property covered by the Chattel Mortgage could be ascertained.

The Referee ruled in favor of respondents as follows:

“Now, if as Mr. Shutan has rhetorically inquired, it had said ‘some’ or ‘part,’ then the Court’s ruling on this point which we make simply for the purpose of identification, referred to as point one, would have to be different because there it would indicate something less than the whole. If it said ‘some’ or a ‘portion’ or a ‘part,’ thereof, there is some doubt as to the construction to be placed on this word ‘certain.’

“But I hold that in a technical statute such as we have here, and in a proceeding such as we have here, the doubt must be resolved in favor of the one who has the equitable side of the case, which in this case is the mortgagee.

“Now, if we had a lawsuit where somebody had purchased some of the fixtures, machinery and equipment for an adequate consideration upon the advice, for instance, of an attorney that this mortgage by its terms did not cover the items purchased, then we would have a different equitable situation. But in a case such as we have here where this point has come up because of the filing of an involuntary petition in bankruptcy and the subsequent adjudication, which vested in the Trustee, the rights, remedies and powers of a lien of a creditor holding a lien by legal or equitable proceeding, I hold that where doubt exists the mortgage should be resolved in favor of the mortgagee.

“Now, this is the doubt—does the word ‘certain’ mean ‘some’ or does it in this case mean ‘all’? We have the word ‘certain’ twice. It says, ‘the Mortgagor mortgages to the Mortgagee all that certain

personal property.' Now, what is meant by that 'certain'? That means all of the property described after the words 'to-wit,' because it says he mortgages 'all that certain personal property situated and described as follows, to-wit.' Of course, there you have the interposition of the word 'all,' and that tends, of course, to clarify the meaning of the word 'certain.' This word 'certain' can mean, as I say, either a part or portion, or it can be a word of description, namely, it could mean and it could be the equivalent, even, of the word 'the.'

"It could be read this way—"That the Mortgagor mortgages to the Mortgagee all that certain personal property situated and described as follows, to-wit: the fixtures, machinery and tooling equipment located at 224 East Palmer Avenue." [Tr. pp. 61-62.]

The preferred definition of the term "certain" is confirmed by other authorities:

Schmidt v. Klipfel, 59 Cal. App. 2d 197, wherein it was held that the words "certain chattel mortgages" in the title of a moratorium act referred to "all" chattel mortgages rather than to only chattel mortgages attached to real property.

Martin v. Bell, 18 N. J. Law 167, wherein it is held that the words "as security for certain notes we hold of others," as used in a promissory note, meant "all" of the notes held.

Black's Law Dictionary (3d Ed.), 1933, which defines "certain" as follows:

"Certain. Ascertained; precise; identified; definitive; clearly known; unambiguous; or, in law, capa-

ble of being identified or made known, without liability to mistake or ambiguity, from data already given. [Citation omitted.]”

It seems clear that the Referee and District Court’s ruling on the meaning of the word “certain” as used in the description in the chattel mortgage at bar should be affirmed.

Conclusion.

Respondents urge that the Referee’s Findings of Fact were fully supported by the evidence. Respondents also urge that the Referee and the United States District Court correctly applied California Law in all respects. Therefore, respondents respectfully submit that the Referee’s decision and the District Court’s affirmance of that decision should be affirmed in all respects.

Respectfully submitted,

FORSTER & GEMMILL,

By DONALD W. CROCKER,

Attorneys for Respondents.

No. 16515

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

A. J. BUMB, Trustee in Bankruptcy of the Estate of
AMPSCO PRODUCTS OF CALIFORNIA, INC., Bankrupt,
Appellant,

vs.

L. E. MCINTYRE and M. H. MCINTYRE, doing business as
L. E. MCINTYRE & Co.,
Appellees.

APPELLANT'S REPLY BRIEF.

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FILED

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L. E. McINTYRE & Co.,
Appellees.

APPELLANT'S REPLY BRIEF.

Appellee's answering brief, entitled "Respondent's Answering Brief", fails substantially, it is submitted, in actually "answering" the legal authority, both statutory and judicial, on the issues herein, as presented in Appellant's Opening Brief. This reply brief of appellant will seek to avoid repeating material already presented in Appellant's Opening Brief, and will be limited to a brief effort to point out a few of the areas wherein appellees have failed to meet headon the impact of the issues actually presented by this appeal.

The basic issue at the trial before the Referee in Bankruptcy, upon the review before the District Court and upon this appeal is whether the language in the subject mortgage sufficiently describes the personal property intended to be made subject to such chattel mortgage so as

to constitute a description considered legally adequate under the law of California. The parties to this appeal are in agreement that California Civil Code Section 2956 requires that the chattel mortgage describe the property. Appellees, in their Point III (page 7 of Answering Brief), completely beg the question on this basic point by blandly volunteering the statement that the subject mortgage instrument complied "with all of the minimum requirements of Section 2956 including a description of the property." Obviously conscious of the lack of substance to such statement as either authority or argument, appellees quickly run for the shelter they may find under the spreading branches of the "equities tree". Alas, this tree is but a mirage for appellees. It is the same cool-blue-lagoon-surrounded-by-palm-trees mirage as was previously glimpsed by the trial court. This is a law case and must be determined and decided by applicable principles of law. It is axiomatic that in a law matter, particularly one of statutory interpretation, the court cannot disregard the applicable and governing law appropriate to the facts of the case and permit itself to be swayed by the size of either the chancellor's foot or the chancellor's heart. At one point, the trial court clearly recognized this. In ruling from the bench, the Referee said:

"There is no equity here, Mr. Shutan. This is just hard, tight-fisted law under the terms of which something may be taken away from a person who in good faith paid a valuable consideration for it purely upon the technicality of a statute. And, so, it is not a case which calls for the exercise of any equitable jurisdiction that the Court may have . . ."

". . . the Court must not permit any sympathy for the claimant or prejudice against the one who resists a claim to interfere with his judgment. He must de-

cide it upon the facts and the law, whatever his private opinion of the law may be as he finds such facts and law to be in a given case.” [Tr. 59.]

The Referee was, of course, correct in such expression. Unfortunately, his heart shortly thereafter overruled him, and he ruled in favor of appellees as the ones who had “the equitable side of the case.” In view of the state of the law of California, this was the essential error in the trial court.

Appellees fall quite short in their effort to limit the authority and significance of *Kahrman v. Jones*, 203 Cal. 254; 263 Pac. 537, wherein the California Supreme Court reiterated the requirement that the provisions of the California Civil Code relating to chattel mortgages must be strictly construed. (See Opening Brief, p. 8.)

In their reference to California case law discussed under Point V of the Answering Brief, appellees make some references which require either comment, amplification or actual correction. Appellees cite the case of *John Breuner Co. v. King*, 9 Cal. App. 271 (Answering Brief, p. 12), in support of their position that the description in the instant mortgage was sufficient. Not only did the mortgage in the *Breuner* case describe “all the furniture, upholstery, carpets, draperies, chinaware and other household goods of every kind . . .”, giving the exact address, but the litigation was between the parties to the mortgage and did not involve the rights of third parties.

In referring to the case of *Pacific States Savings and Loan Company v. Hoffman*, 134 Cal. App. 604, appellees (Answering Brief, p. 13) describes the claimant as a “party not the mortgagor, who apparently was a third party without notice.” A reading of the opinion in this case will show that the claimant was the successor in in-

terest to the mortgagor, and was actually in possession of the personal property in question. (This point was brought to appellees' attention by appellant in oral argument in the District Court.)

At the bottom of page 13, and continuing onto page 14 of the Answering Brief, appellees set forth their version of "principles of California Law . . ." in determining the sufficiency of a description in a chattel mortgage. In item 3 (Answering Brief, p. 14), appellees make the flat statement that if the mortgage contains a specific identification of location "a more specific designation of the property is not required", citing *In re Driscoll*, 127 F. Supp. 81, as authority therefor. This is an absolute misstatement of both the law and of the *Driscoll* case. In the *Driscoll* case, the District Court upheld a chattel mortgage which omitted the street address but which provided a detailed list of the items covered by the mortgage. In that case, Judge Mathes held that where the personal property had been described in sufficient detail so as to enable it to be found and identified on inquiry, the failure to give the address where the property was located did not destroy the validity of the mortgage.

The case of *Witt v. Milton*, 147 Cal. App. 2d 554 cannot be cavalierly "brushed off", as appellees have attempted to do in Point VI of their answering brief. *Witt v. Milton* present a scholarly examination and review of California law on the basic questions presented in the instant appeal. Appellant fails to see the relevance in appellees' reference in the same argument to the Civil Code section governing the method of describing livestock or other animate chattels.

In their Point VII, appellees seek to support the use in evidence of the inventory lists (which were premeditatedly and specifically withheld from the mortgage) upon

the Referee's position that the instrument contained the name and business address of the mortgagor and that an inquiry of such address would have led to the inventory list. This is, indeed, what the Referee held; and this is, indeed, one of the basic errors that the Referee made. Appellant feels that this phase of argument is covered at some length in Argument II of Appellant's Opening Brief. To sustain the trial court on this ground would change and amend the existing law in the State of California with respect to description of property covered by a chattel mortgage to the extent of holding that it is no longer necessary in the State of California to give *any* description of the personal property being made subject to the chattel mortgage, provided that the name and address of the mortgagor appear in the mortgage instrument—upon the theory that such name and address suggest a line of inquiry which puts an interested person upon notice, that he may, nay, *must* go to that address, knock on the door and inquire as to what the parties intended to be covered by the recorded mortgage—and, following through to the logical conclusion, that such interested party may then completely rely upon the information with which he is then provided, assuming that he is provided with any information at all. It is respectfully submitted that without legislating in the manner just stated, a court cannot uphold the subject chattel mortgage upon the Referee's second ground.

There then remains the question of whether the description appearing on the face of the subject mortgage provides an adequate description. The Referee held in his first ground that it did. This is discussed in Appellant's Opening Brief at page 19, *et seq.*, and in Point VIII of appellees' Answering Brief, commencing at page 18 of said brief.

Much is said about the proper use and definition of the word "certain". The case of *In re Mineral Lac Paint Co.*, 17 F. Supp. 1, is discussed at some length in appellant's opening brief for the reason that it is almost "on all fours" with the instant case, and for its thorough and authoritative analysis of the use and meanings of the word "certain" in such a context. Appellees attempt to distinguish the *Mineral Lac* case (Answering Brief, p. 20) on the ground that the *Mineral Lac* case involved an instrument which referred to a schedule of machinery and equipment attached, which, in fact, was not attached; while in the instant case, no reference at all was made to any exhibit or schedule of machinery and equipment. Appellees are in the absurd position of championing the proposition that a failure to make any reference whatsoever to an inventory list or schedule of equipment is more strongly suggestive of a line of inquiry, pursuit of which would lead to such inventory list, than is an express reference in an instrument to a schedule of machinery and equipment "referred to as Exhibit 'A'".

In their efforts to run down a helpful definition of the word "certain", appellees in their Answering Brief (p. 23) again quote from the 1933 Third Edition of Black's Law Dictionary. In both the written and oral argument on the review before the District Court and in Appellant's Opening Brief (p. 20), appellant has cited the 1951 Fourth Edition of Black's Law Dictionary. This edition includes, among its definitions of the word "certain", a citation of the *Mineral Lac* case as authority for the definition "some among possible others". Appellees' loyalty to Black's Third Edition, while understandable, is hardly straightforward presentation.

Appellees seek support in the first definition of the word "certain" appearing in Webster's New International

Dictionary, Second Edition Unabridged, 1948 (Answering Brief, pp. 20, 21), and on page 21 set forth the language of the chattel mortgage as it might appear if the definition selected by appellees is substituted for the word “certain” as used in the subject mortgage. An examination of appellees’ own example of their strongest position illustrates clearly the inadequacy of such language to adequately describe what items of personal property are to be covered by the chattel mortgage.

In holding that the description on the face of the subject mortgage was by itself adequate, the Referee had to stretch and stretch until, like the frog of the old fable, he burst: “Certain” is really equivalent to “the”, and “the” is really the same as “all” and “all” is an “adequate description”. (See Argument in Appellant’s Opening Brief, p. 19, *et seq.*)

The Referee conceded that if the language in the subject mortgage had said “some” or “part” of the machinery, equipment, etc., his ruling would have to be different [Tr. 60], so in this sense even the Referee in not claiming that an address alone obviates the necessity of an adequate description of the personal property to be covered by the mortgage. Furthermore, the Referee also stated [Tr. 60] that if an innocent purchaser for value had purchased some of the fixtures, machinery and equipment for an adequate consideration, subsequent to the subject mortgage, there would be a substantially different situation—with the implication that in such a situation, also, he would have held differently. The Referee made it quite clear that he was ruling in the manner in which he did because of the “equities” of the situation.

This case is one which must be determined upon the basis of the LAW. There is absolutely no authority nor any legal justification for stating that a chattel mortgage

which is legally inadequate and invalid under the Civil Code as against a bona fide purchaser for value is valid, binding and enforceable in favor of the mortgagee as against the mortgagor's trustee in bankruptcy. In this situation there is no separate rule; there is no such double standard.

Upon all of the grounds herein presented, the order of the Referee and the Order of the District Court Affirming the Order of the Referee should be reversed, with instructions to the Court below to enter judgment for appellant trustee in bankruptcy, declaring the subject chattel mortgage to be invalid and that appellees have no lien upon any of the assets of the subject bankrupt estate.

Respectfully submitted,

ROBERT H. SHUTAN,

MILTON FEINERMAN,

Attorneys for Appellant.

No. 16521 ✓

United States
Court of Appeals
for the Ninth Circuit

ELIZABETH B. JOHNSON,

Appellant,

vs.

CHARLES B. MacCOY,

Appellee.

Transcript of Record

Appeal from the United States District Court for the
Southern District of California
Central Division

FILED

SEP 25 1959

PAUL P. O'BRIEN, CLERK

No. 16521

United States
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ELIZABETH B. JOHNSON,

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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NAMES AND ADDRESSES OF ATTORNEYS

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HAROLD W. KENNEDY,
County Counsel;

ROBERT C. LYNCH,
Deputy County Counsel;
1100 Hall of Records,
Los Angeles 12, California.

In the United States District Court, Southern District of California, Central Division

No. 1005-58TE

ELIZABETH B. JOHNSON,

Plaintiff,

vs.

CHARLES B. MacCOY,

Defendant.

COMPLAINT FOR DAMAGES FOR VIOLATION OF RIGHTS GUARANTEED BY THE FOURTEENTH AMENDMENT TO THE UNITED STATES CONSTITUTION

I.

This is an action founded upon the provisions of 42 U.S.C.A., Section 1983, being a part of an act commonly known as the Civil Rights Act, and jurisdiction is conferred upon this Court by reason of the fact that this is an action pursuant to said Act, to redress plaintiff for violations by defendant of rights conferred upon plaintiff by the Fourteenth Amendment to the United States Constitution, said rights being plaintiff's right under said Amendment to be free from all arbitrary and unreasonable physical restraints; to be free in the enjoyment by her of her facilities; and to be free to earn a living by a lawful calling, all of which rights are guaranteed to plaintiff by said Amendment and all of which rights were violated by defendant, as here-

inafter alleged, acting under color of the law of a state of the United States and under color of an office of said state, as hereinafter alleged. Accordingly, jurisdiction is in this Court to hear and determine this matter because the same is one which arises under the federal law.

II.

The plaintiff herein resides at Los Angeles, California, within the Southern District of California.

III.

Defendant herein was at all times herein mentioned a duly qualified and acting judge of the Municipal Court of the Los Angeles Judicial District, County of Los Angeles, State of California (hereinafter called the Municipal Court), which said Municipal Court is a court of limited jurisdiction under the laws of the said state. Each and every act hereinafter mentioned done by the defendant was done by him under color of the law of said state and under color of his office as aforesaid.

IV.

On or about October 28, 1957, defendant while sitting as a magistrate of said Municipal Court issued a felony complaint charging the plaintiff with violating a law of the State of California, to wit: Section 182, subdivision 1, of the California Penal Code and then caused to be issued a warrant for the arrest of plaintiff for said alleged violation. Pursuant to said warrant, plaintiff appeared in

Division Four of the aforesaid Municipal Court in answer thereto where on November 1, 1957, the entire proceedings referred to in the instant paragraph were dismissed by the Honorable Vernon W. Hunt, a Judge of said Municipal Court. A true copy of the oral opinion of the said Judge Hunt as given by him at the time of said dismissal is attached hereto and made a part hereof as plaintiff's Exhibit "A."

V.

The felony complaint referred to in paragraph IV hereof was not presented to defendant for issuance by a law enforcement or prosecutive agency of the State of California nor was said complaint the result of any action on the part of a grand jury of said state or of a grand jury of a county of said state. Said complaint was instead presented to defendant by two private individuals who have no relationship to a prosecutive agency of said state.

VI.

On diverse occasions prior to October 28, 1957, defendant had requested of the District Attorney of the County of Los Angeles that the said District Attorney issue a felony complaint against the plaintiff herein for a violation of the penal law referred to in paragraph IV hereof. Said District Attorney at all times did refuse to issue said complaint.

VII.

Thereafter, on or about December 23, 1957, defendant while again sitting as a magistrate of said

Municipal Court and acting with full and complete knowledge of the refusal of the said District Attorney of the County of Los Angeles to issue a felony complaint against plaintiff for an alleged violation of the aforesaid section 182, subdivision 1, of the California Penal Code and acting with full and complete knowledge of the proceedings had before the said Honorable Vernon W. Hunt, which said proceedings are referred to in paragraph IV hereof, again issued a felony complaint charging plaintiff herein with violating a law of the State of California, to wit: The said section 182, subdivision 1, of the California Penal Code and again caused to be issued a warrant for the arrest of plaintiff herein for said alleged violation.

VIII.

The felony complaint referred to in paragraph VII hereof was not presented to defendant for issuance by a law enforcement or prosecutive agency of the State of California nor was said complaint the result of any action on the part of a grand jury of said state or of a county of said state. Said complaint was instead presented to defendant by a single individual who was one of the two individuals who presented the prior complaint referred to in paragraph IV hereof to defendant. The respective complaints referred to in paragraphs IV and VII hereof were identical in every respect except that the complaint referred to in paragraph VII hereof was signed by a single one of the two individuals who signed the complaint referred to in paragraph IV

hereof. Each of said complaints was prepared by individuals who bore no relationship to any prosecutive agency of the State of California.

IX.

On or about December 23, 1957, acting pursuant to the warrant referred to in paragraph VII hereof, the Sheriff of the County of Los Angeles, through his authorized deputies, requested the plaintiff herein to present herself at his office in the said County of Los Angeles on December 24, 1957. On December 24, 1957, plaintiff did present herself at the office of the said Sheriff and was for a time on said day restrained of her liberty at said place by the said Sheriff, acting pursuant to said warrant.

X.

In issuing the complaint referred to in paragraph VII hereof and in causing the issuance of the warrant referred to in paragraph VII hereof, defendant did an act of an official nature in the clear absence of any color of jurisdiction to so act and the proceedings so engaged in by him were at all times herein mentioned a nullity. Plaintiff is informed and believes and therefore alleges that defendant issued said complaint referred to in paragraph VII hereof and caused the issuance of the warrant referred to in said paragraph VII in bad faith. Plaintiff is further informed and believes and on that ground alleges that the sole reason for the issuance by the defendant of the aforesaid com-

plaint of December 23, 1957, and the sole reason for causing the issuance of the aforesaid warrant of arrest pursuant thereto was to promote the interests of the two individuals who presented the said complaint of December 23, 1957, and the complaint of October 28, 1957, to him.

XI.

The restraint of plaintiff referred to in paragraph IX hereof was caused solely, directly and intentionally by the defendant and said restraint violated the rights of plaintiff herein to be free from all arbitrary and unreasonable physical restraints, to be free in the enjoyment of her facilities, and to be free to earn a living by a lawful calling, which said rights belong to the plaintiff herein by virtue of the Fourteenth Amendment to the United States Constitution.

XII.

As a result of the deprivation of her said rights as aforesaid, plaintiff herein was damaged in the sum of \$25,000.00.

Wherefore, plaintiff prays for judgment in the sum of \$25,000.00; for costs of suit; and for such other and further relief as the Court deems proper.

/s/ MARVIN ZINMAN,
Attorney for Plaintiff.

EXHIBIT A

People vs. H. A. Blackman, George Batchelor and Elizabeth B. Johnson, Municipal Court of Los Angeles Judicial District No. 141255. Opinion of Honorable Vernon W. Hunt, Judge presiding in Division 4 thereof. Proceedings of November 1, 1957:

Judge Hunt: "I have given this matter a great deal of careful thought and research on my own, because this matter goes far beyond the individuals who are involved in this particular case. It involves the liberty of everyone in this courtroom and all of our citizens. Now, anything that I say here now does not apply to the individuals who obtained this Complaint. I know nothing about the merits or demerits of this present controversy. I am not passing judgment on it at all. I am not passing judgment on George C. Finn and Charles C. Finn. I do not know the gentlemen. I know nothing about them or what their purpose was in instituting this litigation, but I am concerned, what I am concerned about, is whether or not some unscrupulous, disreputable, dishonorable, irresponsible individual might be able some day if I set a precedent here, that the District Attorney doesn't have to file these cases, might some day be able to have his neighbor arrested on a false charge out of a pure spirit of vengeance and hatred, falsely. This is a tremendously serious thing. The issues at stake here are enormous. To think that any of our good citizens who could some

day be subjected to the mere whim of somebody who wanted to humiliate or embarrass him by filing a Complaint, a false one, and under this Statute, Section 806, Section 813 of the Penal Code as they were amended in 1951, all they would have to do would just simply go over to the Judge and swear to a false Complaint charging his neighbor with murder. Say nothing else, and if this is the law, then if the Judge refused to grant the issuance of a warrant on that Complaint, false Complaint, they would be entitled to go through the District Court of Appeals and get a writ of mandamus compelling the Judge to issue the warrant. I don't think that can be the law of this State. If that is the statutory law, it is unconstitutional.

“Now, we have some sections which I think are quite clear and I don't think we have to hold any statute unconstitutional, because I think all of the statutes have to be read together. First we start out with Section 684 of the Penal Code which says a criminal action is prosecuted in the name of the People of the State of California. Not in the name of Mr. Finn and his brother, but the name of the People of the State of California and that's the way this Complaint has been filed here. It is entitled “The People of the State of California versus H. A. Blackman,” and so forth. It is not entitled Finn versus Blackman. It the People, the whole People of the State of California who are interested in felony prosecutions.

“Then we have the Constitutional Section which

says "The style of all process shall be The People of the State of California and all prosecutions shall be conducted in their name and by their authority." Not by the authority of some irresponsible individual. I am not saying the Finns are irresponsible. I say at the outset I am not referring to them. I can conceive of a situation where some person might file a perfectly proper Complaint, an honest one, a true one, not talking about that, because if we permit one to file, then we will have to permit them all to file it, and we will have no way of determining whether they are false or not until after they have been arrested, thrown in jail, out on bail if they get bail and in a murder case they wouldn't even get it, and if they had a \$5,000.00 bail put on them, as was put on them in this case, it would cost them a \$500.00 bail premium before they ever got out of jail just to find out whether they are innocent or not.

"All right, then we proceed to the Government Code. By the way, the Constitutional Article is Article 6, Section 20. We will proceed now to the Government Code which tells us what the District Attorney's function is, and I think it is very clear. "The District Attorney shall institute." That means just what it says. Begin, proceed, institute proceedings before the Magistrate before the arrest of persons charged with or reasonably suspected of public offenses when he has information that such offenses have been committed." This has not been instituted by the District Attorney. It was instituted by Mr.

Finn and his brother. That's Government Code Section 26501. I feel that in requiring that all criminal sections must be prosecuted in the name of and by the authority of the People of the State of California, and that the District Attorney shall be the person to exercise that authority by instituting proceedings before the Magistrate, the framers of the Constitution and the Legislators must have had in mind the safeguards necessary to protect innocent citizens from being falsely accused by irresponsible or unscrupulous individuals and being deprived of their liberty by being arrested on a warrant obtained on a false Complaint filed by such irresponsible or unscrupulous individuals who know nothing about law and may be interested only in harassing and humiliating the accused person. If any of our present Statutes can be said to permit criminal proceedings to be instituted by such individuals, it is the opinion of this Court that they are unconstitutional and void.

“I would refer you to the case of Fitch versus Board of Supervisors, 122 Cal., 285 at 289. There is some language in the District Court of Appeal of this District, the Second Appellate District, to the effect that the trial and punishment of felonies is an activity in which the people of the entire State are interested, and such matters which require governmental attention must be handled by the State through its duly designated officials, and not by unauthorized individuals who may seek to use the process of the Courts for their personal purposes.

I refer you to the case of Sloan versus Hamilton, 81, Cal. App., 90. The Supreme Court, People versus McDaniels, 137 Cal., 192, at 198, "All prosecutions are by the State which is the single entity. It may choose the form and demeanor for what particular offense it will prosecute the citizens for a violation of the Criminal Law." In other words, these individuals filing these things probably get themselves in the wrong Court half the time and they'll file the wrong charges. They won't know anything about law. It is just unthinkable that this sort of thing could exist in our Nation.

"As far as this Court is concerned, it is not going to. The motion to quash the warrant is granted. The Complaint is stricken and dismissed, and the defendants are discharged."

[Endorsed]: Filed October 21, 1958.

[Title of District Court and Cause.]

NOTICE OF MOTION TO DISMISS

To Elizabeth B. Johnson, plaintiff herein, and to Marvin Zinman, her attorney:

You and each of you, will please take notice that on Monday, the 24th day of November, 1958, at 10:00 a.m., or as soon thereafter as counsel can be heard, in the above-entitled court, before the Honorable William C. Mathes, Judge thereof, at the Fed-

eral Building, Los Angeles, California, the defendant, Charles B. MacCoy, will move said court for an order dismissing the above-entitled action against said defendant on the following ground.

That the complaint fails to state a claim upon which relief can be granted.

Said motion will be based upon the pleading heretofore filed and the points and authorities attached hereto.

HAROLD W. KENNEDY,
County Counsel, and

ROBERT C. LYNCH,
Deputy County Counsel,

By /s/ ROBERT C. LYNCH,
Attorneys for Defendant,
Charles B. MacCoy.

[Endorsed]: Filed November 13, 1958.

[Title of District Court and Cause.]

ORDER ON DEFENDANT'S MOTION
TO DISMISS

This cause having come before the Court for hearing on defendant's motion to dismiss, filed November 13, 1958; and the motion having been argued and submitted for decision;

It Is Ordered that defendant's motion to dismiss is hereby granted, with leave to plaintiff to serve and file an amended complaint within twenty days.

It Is Further Ordered that the Clerk this day serve copies of this order by United States mail upon the attorneys for the parties appearing in this cause.

March 27, 1959.

/s/ WM. C. MATHES,
United States District Judge.

[Endorsed]: Filed March 30, 1959.

United States District Court for the Southern District of California, Central Division.

No. 1005-58—WM

ELIZABETH JOHNSON,
Plaintiff,
vs.
CHARLES B. McCoy,
Defendant.

JUDGMENT OF DISMISSAL

It appearing that on March 27, 1959, the Court ordered the within action Dismissed, with leave to plaintiff to serve and file an amended complaint within twenty days from the date of the Order of

Dismissal, if so advised, and that the plaintiff has failed to offer any amendment within the time so allowed, now, therefore, upon the Court's own initiative,

It Is Ordered, Adjudged and Decreed that the above-entitled action be and hereby is dismissed.

It Is Further Ordered that this Judgment of Dismissal shall not constitute an adjudication upon the merits (Fed.R.Civ.P., Rule 41 (b)).

It Is Further Ordered that the Clerk this day serve copies of this Order by United States mail upon the parties appearing in this cause.

April 30, 1959.

/s/ WM. C. MATHES,
United States District Judge.

[Endorsed]: Filed and entered April 30, 1959.

[Title of District Court and Cause.]

NOTICE OF APPEAL

With affidavit of service as to Harold W. Kennedy, County Counsel, and Robert C. Lynch, Deputy, 1100 Hall of Records, Los Angeles 12, California.

Notice Is Hereby Given, that Elizabeth B. Johnson, the plaintiff above-named, hereby appeals to

the United States Court of Appeals for the Ninth Circuit from the Order of March 27, 1959, herein, granting the motion of the defendant Charles B. MacCoy to dismiss the complaint.

/s/ MARVIN ZINMAN,
Attorney for Appellant
Elizabeth B. Johnson.

Proof of Service by Mail attached.

[Endorsed]: Filed April 24, 1959.

[Title of District Court and Cause.]

NOTICE OF APPEAL

Notice Is Hereby Given, that Elizabeth B. Johnson, the plaintiff above named, hereby appeals to the United States Court of Appeals for the Ninth Circuit from the judgment of dismissal in favor of defendant and against plaintiff heretofore entered herein on April 30, 1959.

/s/ MARVIN ZINMAN,
Attorney for Appellant,
Elizabeth B. Johnson.

Proof of Service by Mail attached.

[Endorsed]: Filed May 15, 1959.

[Title of District Court and Cause.]

CERTIFICATE BY THE CLERK

I, John A. Childress, Clerk of the above-entitled Court, hereby certify that the foregoing documents together with the other items, all of which are listed below, constitute the transcript of record on appeal to the United States Court of Appeals for the Ninth Circuit, in the above-entitled case; and that said items are the originals unless otherwise shown on this list:

Names and Addresses of Attorneys.

Complaint, filed 10/21/58.

Notice of Taking Deposition, filed 11/12/58.

Notice of Motion to Dismiss and Points and Authorities, filed 11/13/58.

Order on Defendant's Motion to Dismiss, filed 3/30/59.

Judgment of Dismissal, filed and entered 4/30/59.

Notice of Appeal, filed 4/24/59.

Notice of Appeal, filed 5/15/59.

Designation of contents of Record on Appeal, filed 5/26/59.

Dated: June 18, 1959.

[Seal]

JOHN A. CHILDRESS,
Clerk;

By /s/ WM. A. WHITE,
Deputy Clerk.

In the United States Court of Appeals
For the Ninth Circuit

No. 16521

ELIZABETH B. JOHNSON,

Appellant,

vs.

CHARLES B. MacCOY,

Appellee.

APPELLANT'S STATEMENT OF POINTS
AND DESIGNATION OF RECORD
(Rule 17(6), Rules, Court of Appeals,
Ninth Circuit)

To the Court of Appeals for the Ninth Circuit:

The points upon which appellant intends to rely are:

1. The District Court erred in granting the defendant-appellee's motion to dismiss the complaint.

Appellant designates the following portions of the record herein as being material to this appeal and for printing:

1. The Complaint;
2. Notice of Motion to Dismiss;
3. Order on Motion to Dismiss; and
4. Judgment of Dismissal.
5. Notice of Appeal.

Dated: June 29, 1959.

/s/ MARVIN ZINMAN,
Attorney for Appellant.

[Endorsed]: Filed June 30, 1959.

[Endorsed]: No 16521. United States Court of Appeals for the Ninth Circuit. Elizabeth B. Johnson, Appellant, vs. Charles B. MacCoy, Appellee. Transcript of Record. Appeal from the United States District Court for the Southern District of California, Central Division.

Filed June 19, 1959.

Docketed: June 30, 1959.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for
the Ninth Circuit.

No. 16521.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

ELIZABETH B. JOHNSON,

Appellant,

vs.

CHARLES B. MACCOY,

Appellee.

APPELLANT'S OPENING BRIEF.

MARVIN ZINMAN,

315 West Ninth Street,
Los Angeles 15, California,

Attorney for Appellant.

FILED

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PAUL P. D'ONOFRI, CLERK

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No. 16521.
IN THE
United States Court of Appeals
FOR THE NINTH CIRCUIT

ELIZABETH B. JOHNSON,

Appellant,

vs.

CHARLES B. MACCOY,

Appellee.

APPELLANT'S OPENING BRIEF.

Jurisdictional Statement.

1. Jurisdiction in the District Court.

The District Court had jurisdiction of this action by virtue of the provisions of Section 1983, Title 42, United States Code (which section is a part of an act commonly called the Civil Rights Act) in that the complaint alleged the violation of a right in the plaintiff protected by the Fourteenth Amendment to the United States Constitution [R. 8] by one *i.e.*, the defendant, acting under color of the law and office of a State [R. 4]. While there has been some confusion as to the existence of jurisdiction in the District Court under these allegations, it now seems clear that these allegations do give the District Court jurisdiction, *Walton v. City of Atlanta*, 181 F. 2d 693 (C. A. 5, 1950); *Oppenheimer v. Stillwell*, 132 Fed. Supp. 761 (D. C. Cal., 1955) (denying a motion to dismiss for lack of jurisdiction; granting a motion to dismiss on immunity grounds).

2. Jurisdiction of the Court of Appeals to Review the Judgment of the District Court.

This Court has jurisdiction to review the judgment of the District Court by virtue of Section 1291, Title 28, United States Code, in that a final judgment was entered by said Court on April 30, 1959 [R. 15, 16] from which notice of appeal was served and filed on May 15, 1959 [R. 17]. The record [R. 16, 17] reflects that a notice of appeal was also served and filed on April 24, 1959; said notice was protective only and pertained to the District Court's order granting motion to dismiss [R. 14, 15], filed March 27, 1959 and which preceded the judgment, as aforesaid.

Statement of the Case.

This is an action under Section 1983, Title 42, United States Code, the Civil Rights Act, to redress an alleged violation of rights protected by the Fourteenth Amendment to the United States Constitution [R. 8]. Money damages are sought [R. 8]. The defendant moved to dismiss the complaint on the ground that the complaint failed to state a claim for relief [R. 13, 14]. Said motion was granted; no reasons for the granting thereof were given and no written opinion was filed [R. 14, 15]. Plaintiff chose to stand upon her complaint and this appeal followed.

In the view of counsel for plaintiff, the motion to dismiss was granted because the District Court held the view that the defendant had an immunity from the claim stated in the complaint. Accordingly, the question on this appeal is whether the defendant did have an immunity from suit under the allegations of the complaint cognizable by motion to dismiss.

Specification of Error.

Appellant contends that the District Court erred in granting the motion to dismiss.

ARGUMENT.

While Defendant as a Judicial Officer Has a Broad Immunity From Suit, an Exception to This Immunity Does Exist Which Is Applicable Here.

The complaint alleges that the defendant is a judicial officer [R. 4] and admittedly as such he has a broad immunity from suit. *Bradley v. Fisher*, 80 U. S. 355 (1871). However, an exception to the rule of immunity does exist which should have been applied by the District Court to the complaint before it. Said exception is best set forth in the case most often cited for the proposition that the immunity exists, *Bradley v. Fisher, supra*, as follows:

“A distinction must be here observed between excess of jurisdiction and the clear absence of all jurisdiction over the subject matter. Where there is clearly no jurisdiction over the subject matter any authority exercised is usurped authority, and for the exercise of such authority, when the want of jurisdiction is known to the judge, no excuse is permissible.”

Said exception to the rule of immunity has been more recently recognized and is still the law. *Kenney v. Fox*, 232 F. 2d 288 (C. A. 6, 1956); *Ryan v. Scoggin*, 245 F. 2d 54 (C. A. 10, 1957).

An examination of the complaint shows that the exception to the rule of immunity was alleged therein. Indeed such examination shows that the pleader had the immunity rule and the exception thereto in mind in drafting

the complaint. If the allegations as to the exception in the complaint are not sufficient, it must be said that no complaint at all can ever be drafted so as to litigate the issue of whether the exception to the rule should apply. The writer of this brief concedes that allegations of malice, ill will and bad faith are not sufficient to pierce the immunity which a judicial officer enjoys, and this complaint does not contain allegations of malice and ill will, although there is an allegation of bad faith [R. 7] material for reasons other than that of pleading the exception to the rule of immunity. The writer, who also drafted the complaint, does however believe that there are allegations in the complaint sufficient at least to allow the issue to be litigated beyond the pleading stage.

It is noted that the complaint alleges that the defendant first, on October 28, 1957, issued a felony complaint charging plaintiff with the violation of a crime and that he then caused a warrant to be issued for her arrest [R. 4, 5]. This first felony complaint and warrant were not issued in accordance with the law of California and it is alleged that the same did not result from action of the part of the regular prosecutive agencies of the State, nor of a grand jury thereof [R. 5]. The proceedings so commenced were shortly dismissed by defendant's brother judge who, in so doing, gave an opinion from the bench in which he held that the defendant did not have any jurisdiction to do as he did. This opinion was reported; it is a part of the complaint [R. 5, 9, 10, 11, 12, 13]; and the complaint alleges that defendant knew of this ruling and opinion when he acted a second time [R. 6].

Appellant concedes that had the appellee stopped with the first complaint and warrant, she probably could not have pierced his immunity. The complaint does not rely

on these first acts to come within the exception. It is when he acted a second time [R. 5, 6], with knowledge of the prior dismissal [R. 6], that the immunity he otherwise enjoys, for pleading purposes at least, was denied to him.

The pleader attempted to plead, as the rules of pleading require, Rule 8, Federal Rules of Civil Procedure, the "ultimate facts" as to the exception as well as to the remainder of the claim for relief. The complaint contained the allegation that the defendant "did an act of an official nature in the clear absence of any color of jurisdiction to act" [R. 7]. The purpose of this allegation was to clearly call the exception into play and the allegation is based directly on the rule announced in *Bradley v. Fisher*, *supra*. It is submitted that this allegation does not fall within the same class as allegations of malice and ill will *i.e.*, formula allegations to defeat immunity, but is instead an allegation of an ultimate, though mixed, fact which under *Bradley v. Fisher* is operative to allow the case to come to issue.

Conclusion.

It is submitted that even a judicial officer may, under one circumstance at least, lose his immunity from suit. That circumstance is where he acts in the clear absence of jurisdiction with the knowledge that he is without jurisdiction to act. This complaint alleges this circumstance and the District Court erred in granting the motion to dismiss because of it.

Respectfully submitted,

MARVIN ZINMAN,

Attorney for Appellant.

No. 16521
IN THE
United States Court of Appeals
FOR THE NINTH CIRCUIT

ELIZABETH B. JOHNSON,

Appellant,

vs.

CHARLES B. MACCOY,

Appellee.

APPELLEE'S BRIEF.

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No. 16521

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

ELIZABETH B. JOHNSON,

Appellant,

vs.

CHARLES B. MACCOY,

Appellee.

APPELLEE'S BRIEF.

Facts.

This action is brought under the provisions of the Federal Civil Rights Act, 42 U. S. C. A. Sec. 1983 (R3). It is alleged in appellant's complaint that the appellee, who was and is a duly qualified and acting judge of the Municipal Court of the Los Angeles Judicial District, acting as a magistrate, issued warrants for plaintiff's arrest [R. 4, 6]; that these warrants were issued after the filing of a complaint by a person or persons who were not public prosecutors [R. 5, 6]; that on one occasion appellant appeared in Division 4 of the Municipal Court in answer to one of the warrants of arrest [R. 4, 5]; and that appellant was for a time, on December 24, 1957, restrained of her liberty at the office of the Sheriff of Los Angeles County by the Sheriff acting pursuant to one of these warrants [R. 7]. Plaintiff further alleges that this latter restraint violated her rights under the Fourteenth Amendment of the United States Constitution to be free from all arbitrary and unreasonable physical restraints, to be free in the enjoyment of her facilities and to be free to earn a living by a lawful calling [R. 8].

POINT I.

The Federal Court Is Without Jurisdiction Under the Federal Civil Rights Act, Since Appellant's Complaint Does Not Allege Facts Showing That She Was Deprived of Any Rights, Privileges or Immunities Secured by the Constitution and Laws of the United States.

In 42 U. S. C. A. 1983, by which appellant contends the district court had jurisdiction of this action, it is provided:

“Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any state or territory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to *the deprivation of any rights, privileges, or immunities secured by the Constitution and laws*, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.” (Emphasis ours.)

It is clear from reading this section that before there can be an action under this section there must be a deprivation of rights, privileges or immunities secured by the Constitution and laws of the United States.

Only rights or privileges granted, secured or protected by the Federal Constitution or laws of the United States can be made the basis of an action under the civil rights statutes.

Kenney v. Killian, 133 Fed. Supp. 571, 577; aff. 232 F. 2d 288;

Earle C. Anthony, Inc. v. Morrison, 83 Fed. Supp. 494, 495; aff. 173 F. 2d 897.

It is not intended by the Civil Rights Act that all matters formerly within the exclusive cognizance of states should become matters of national concern.

Snowden v. Hughes, 321 U. S. 1; 88 L. Ed. 497, 505.

Under the Civil Rights Act a cause of action arises only where a right created by the Federal Constitution or laws has been violated and violation of state laws is not sufficient.

Ortega v. Rogen, 216 F. 2d 561.

Invasions of purely personal rights the protection of which is within the domain of state powers does not come under the protective shield of general national sovereignty or of statutes such as civil rights statutes.

Hardyman v. Collins, 80 Fed. Supp. 501, 505.

Although the appellant has alleged that the acts of the appellee herein violated rights conferred upon her by the Fourteenth Amendment to the United States Constitution, said rights being the appellant's right to be free from all arbitrary and unreasonable physical restraints, to be free in the enjoyment of her facilities and to be free to earn a living by lawful calling [R. 3], the facts alleged show nothing more than that she was restrained of her liberty for a time on December 24, 1957, pursuant to a warrant issued by the defendant [R. 7]. Such an allegation at the most would amount to an allegation of false imprisonment, which may be redressed under the state law of California, and no facts appear which would give a court jurisdiction of this matter under the Federal Civil Rights Act.

In *Agnew v. City of Compton*, 239 F. 2d 226, plaintiff brought an action for damages under the Federal Civil Rights Act, alleging that defendants arrested him without a warrant and transported him to jail. It was further alleged that these acts were committed as a part of a conspiracy to deprive the plaintiff of numerous federal rights secured by the Constitution and federal statutes, including the rights to sell personal property, liberty of contract, equal protection of the law, due process of law, to work and earn a living, to live where one wills, personal liberty, peace and quiet, freedom of movement, privacy, and free speech.

In holding that no cause of action was stated under the Federal Civil Rights Act, 42 U. S. C. A. 1983, the court said at page 231:

“Here, however, it is alleged that the arrest was spiteful, malicious, wrongful, and oppressive. This precludes the assumption that the officers proceeded under an honest misunderstanding of the ordinance. With these additional allegations, it would appear that the complaint states a common-law action for false arrest and imprisonment. It does not, however, state a cause of action under the Civil Rights Act, absent allegations that the purpose of the arrest was to discriminate between persons or classes of persons. Were the rule otherwise, every common-law action for false arrest would be cognizable in the federal courts under the Civil Rights Act.

“But there is also to be considered the further allegation that such arrest was made for the purpose of denying plaintiff his rights, privileges, and immunities under the Constitution.

“General allegations of this kind, when unsupported by the complaint, read as a whole, have consistently been rejected as insufficient. * * *.”

The Court further said:

“In what is said above, we do not mean to hold that a cause of action may never be stated where false arrest and imprisonment are involved. As before indicated, such a cause of action may be stated where it is alleged that the arrest was for the purpose of discriminating between persons or classes of persons. There is here no such allegation.”

In the instant case there is no allegation in appellant's complaint that her arrest and detention was for the purpose of discriminating between persons or classes of persons.

II.

Appellant's Complaint Fails to State a Claim Upon Which Relief Can Be Granted.

A. A Judge Is Not Liable in a Civil Action Under the Federal Civil Rights Act for Acts Done by Him in the Exercise of His Judicial Functions.

The only acts alleged by the appellant to have been done by the appellee are the issuance of two warrants of arrest which are acts done in his capacity as a magistrate [R. 4, 5].

The law is well established in a great number of cases that a judge is not liable for damages for acts done in his judicial capacity in a matter over which the court has jurisdiction of the subject matter and parties although such an act was in excess of his jurisdiction or otherwise erroneous and that this rule of immunity has not been abrogated by the Civil Rights Act.

In *Bradley v. Fisher*, 80 U. S. 355, 20 L. Ed. 646, the United States Supreme Court stated at page 649 that where a judge performs a judicial act within the jurisdiction of the court, he cannot be subject to responsibility in a civil action however erroneous the act may have been and however injurious in its consequences it may have proved to the plaintiff. The Supreme Court further stated that it is a general principle of highest importance to the proper administration of justice that a judicial officer in exercising the authority vested in him shall be free to act without apprehension of personal consequence to himself.

Among the many cases which have stated the basic rule of judicial immunity are:

- Carpenter v. Dethmers*, 253 F. 2d 131;
- Blackmon v. Wagener*, 253 F. 2d 10 (cert. denied 78 Sup. Ct. 1390, 2 L. Ed. 2d 1554);
- Spriggs v. Pioneer Carissa Gold Mines, Inc.*, 251 F. 2d 61;
- Cuiksa v. City of Mansfield*, 250 F. 2d 700;
- Holmes v. Henderson*, 249 F. 2d 529;
- Ryan v. Scroggin*, 245 F. 2d 54;
- Watson v. Skillman*, 242 F. 2d 659;
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- Cawley v. Warren*, 216 F. 2d 74;
- Francis v. Crafts*, 203 F. 2d 809;

Miller v. Middletown State Hospital, 164 Fed. Supp. 674;

Oppenheimer v. Stillwell, 132 Fed. Supp. 760;

Kenney v. Hatfield, 132 Fed. Supp. 814 (affirmed 232 F. 2d 288);

Peters v. Carson, 126 Fed. Supp. 137.

The rule in the State of California is the same as it is in the federal courts in this respect. In *Perry v. Meikle*, 102 Cal. App. 2d 602, the court stated at page 605 that judges of courts of record of superior or general jurisdiction are not liable in civil actions for their judicial act even when such actions are in excess of their jurisdiction and are alleged to have been done maliciously and corruptly.

It is clear that as a judge of the Municipal Court of Los Angeles Judicial District the appellee was a magistrate (Penal Code of the State of California, Sec. 808 (4)) and as a magistrate had jurisdiction to issue warrants of arrest when a complaint was filed with him charging a public offense triable in the Superior Court of the county in which he sits (Penal Code of the State of California, Sec. 813).

B. The Facts Alleged in Appellant's Complaint Do Not Set Forth a Basis for an Exception to the Basic Rule of Judicial Immunity.

The appellant bases her argument on a claimed exception to the rule of judicial immunity arising from the allegation that the appellee, sitting as a magistrate, issued a second warrant of arrest with knowledge that another judge of the municipal court had dismissed the proceedings against the appellant following the issuance of the first warrant of arrest by the appellee. (Op. Br.

p. 5.) This exception to the rule of judicial immunity, it is claimed, arises under the language of *Bradley v. Fisher*, *supra*, 80 U. S. 335, 20 L. Ed. 646, which holds that this rule of immunity is lost where there is a clear absence of all jurisdiction over the subject matter and the want of jurisdiction is known to the judge.

While it appears to be the appellant's basic contention that a magistrate is without jurisdiction to issue a warrant of arrest, or otherwise act following the filing of a complaint with him by a person other than a public prosecutor, she points to no statute, appellate court decision or other legal authority so providing. We have been unable to find any direct authority in point on this specific question. It, therefore, appears that this question has not yet been settled in California.

It is clear, however, that magistrates have general jurisdiction to issue warrants of arrest (Penal Code of the State of California, Sec. 813). In *Bradley v. Fisher*, *supra*, 80 U. S. 355, immediately following the language quoted and relied upon by the appellant in her brief, the court said:

“* * * But where jurisdiction over the subject matter is invested by law in the judge, or in the court which he holds, the manner and extent in which the jurisdiction shall be exercised are generally as much questions for his determination as any other questions involved in the case, although upon the correctness of his determination in these particulars the validity of his judgments may depend. Thus, if a probate court, invested only with authority over wills and the settlement of estates of deceased persons, should proceed to try parties for public offenses, jurisdiction over the subject of offenses be-

ing entirely wanting in the court, and this being necessarily known to its judge, his commission would afford no protection to him in the exercise of the usurped authority. But if, on the other hand, a judge of a criminal court, invested with general criminal jurisdiction over offenses committed within a certain district, should hold a particular act to be a public offense, which is not by the law made an offense, and proceed to the arrest and trial of a party charged with such act, or should sentence a party convicted to a greater punishment than that authorized by the law upon its proper construction no personal liability to civil action for such acts would attach to the judge, although those acts would be in excess of his jurisdiction, or of the jurisdiction of the court held by him, for these are particulars for his judicial consideration, whenever his general jurisdiction over the subject matter is invoked. Indeed, some of the most difficult and embarrassing questions which a judicial officer is called upon to consider and determine relate to his jurisdiction, or that of the court held by him, or the manner in which the jurisdiction shall be exercised. And the same principle of exemption from liability which obtains for errors committed in the ordinary prosecution of a suit where there is jurisdiction of both subject and person, applies in cases of this kind, and for the same reasons."

When the complaints were presented to the appellee acting as a magistrate by the two private individuals in one instance [R. 5] and the single individual in the other instance [R. 6], his general jurisdiction over the subject matter was invoked. It then became his duty to decide

whether or not he had jurisdiction over the case in view of the fact that the complaints were filed by individuals and not by public prosecutors. The making of this decision was an act which the appellee had jurisdiction to perform and which he could not refuse to perform. In making this decision there was no pertinent statute or appellate court decision to assist him and it was, therefore, a question which the appellee must decide for himself. He decided that he had jurisdiction to issue the warrants for the appellant's arrest and to proceed with the case. Clearly this is not a case in which there was a clear absence of all jurisdiction over the subject matter and where the want of such jurisdiction was known to the judge.

It is contended that the prior dismissal of the matter by another judge of the municipal court was binding on Judge MacCoy as to his jurisdiction and deprived him of his judicial immunity if he should disagree with the views of Judge Hunt. We do not believe that it can be seriously contended that the decision in *Bradley v. Fisher* requires one judge of a municipal court to be bound by the views of another judge of the same court as to his jurisdiction as magistrate to issue a warrant of arrest in a particular case at the peril of personal financial liability in the absence of a statute or appellate court decision clearly in point. If the appellant were able to point to some clear and conclusive legal authority known to the appellee at the time he issued the warrants for her arrest and holding that he was without jurisdiction under the circumstances, there might be some basis to her contention. This she has not done.

In the absence of the allegation of any facts providing a legal basis for an exception to the rule of judicial im-

munity, the appellee, Judge MacCoy, enjoys such judicial immunity and the appellant's complaint fails to state a claim upon which relief can be granted.

Conclusion.

We submit that in this matter, appellant has not pleaded facts showing that she was deprived of any rights, privileges or immunities secured by the constitution and laws of the United States and therefore the Federal District Court was without jurisdiction of the matter.

Appellee, all of whose acts were done in his capacity as a magistrate has judicial immunity from civil liability under the Civil Rights Act as conclusively established by a long line of cases.

Appellant has not alleged facts showing that this was a matter in which appellee acted in the face of a clear absence of jurisdiction and when such absence of jurisdiction was known to him. In the absence of the allegation of such facts her complaint fails to state a claim upon which relief can be granted and the district court properly granted appellee's motion to dismiss the complaint.

The judgment of the District Court should be affirmed, with costs on appeal awarded to the appellee.

Respectfully submitted,

HAROLD W. KENNEDY,

County Counsel

By ROBERT C. LYNCH,

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Attorney for Appellee.

No.

16522 ✓

In the United States Court of Appeals
for the Ninth Circuit

UNITED STATES OF AMERICA, PETITIONER

v.

HONORABLE JAMES M. CARTER, RESPONDENT

BRIEF IN SUPPORT OF PETITION FOR WRIT
OF MANDAMUS

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In the United States Court of Appeals
for the Ninth Circuit

No. _____

UNITED STATES OF AMERICA, PETITIONER

v.

HONORABLE JAMES M. CARTER, RESPONDENT

BRIEF FOR PETITIONER

JURISDICTIONAL STATEMENT

1. The jurisdiction of this Court is based on the All Writs Act, 28 U.S.C. 1651, which provides:

Writs. (a) The Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law.

(b) An alternative writ or rule nisi may be issued by a justice or judge of a court which has jurisdiction.

There is no time limit set out in the All Writs Act or in any other statute for the filing of a writ of mandamus.¹ Furthermore, Rule 35 of the Rules of

¹ The Reporter's Transcript of Proceedings at the time of the hearing on the motion to correct sentences is dated May 30, 1959 and was not received by the Petitioner until June 5, 1959.

Criminal Procedure states: "The court may correct an illegal sentence at any time." Since a court may of its own correct an illegal sentence at any time, it follows that it may be ordered to correct an illegal sentence at any time.

2. An appeal from the order of Judge Carter would not lie in these cases. The statute which sets out the grounds on which the United States may appeal from an adverse decision in a criminal case is the Criminal Appeals Act, 18 U.S.C. 3731, which provides as follows:

Appeal by United States.—An appeal may be taken by and on behalf of the United States from the district courts direct to the Supreme Court of the United States in all criminal cases in the following instances:

From a decision or judgment setting aside, or dismissing any indictment or information, or any count thereof, where such decision or judgment is based upon the invalidity or construction of the statute upon which the indictment or information is founded.

From a decision arresting a judgment of conviction for insufficiency of the indictment or information, where such decision is based upon the invalidity or construction of the statute upon which the indictment or information is founded.

From the decision or judgment sustaining a motion in bar, when the defendant has not been put in jeopardy.

An appeal may be taken by and on behalf of the United States from the district court to a court of appeals in all criminal cases, in the following instances:

From a decision or judgment setting aside, or dismissing any indictment or information, or any count thereof except where a direct appeal to the Supreme Court of the United States is provided by this section.

From a decision arresting a judgment of conviction except where a direct appeal to the Supreme Court of the United States is provided by this section.

The appeal in all such cases shall be taken within thirty days after the decision or judgment has been rendered and shall be diligently prosecuted.

Pending the prosecution and determination of the appeal in the foregoing instances, the defendant shall be admitted to bail on his own recognizance.

If an appeal shall be taken, pursuant to this section, to the Supreme Court of the United States which, in the opinion of that Court, should have been taken to a court of appeals, the Supreme Court shall remand the case to the court of appeals, which shall then have jurisdiction to hear and determine the same as if the appeal had been taken to that court in the first instance.

If an appeal shall be taken pursuant to this section to any court of appeals which, in the opinion of such court, should have been taken directly to the Supreme Court of the United States, such court shall certify the case to the Supreme Court of the United States, which shall thereupon have jurisdiction to hear and determine the case to the same extent as if an appeal had been taken directly to that Court.

Appeals in criminal cases may not be taken by the Government unless authorized by the Criminal Appeals Act. *United States v. Borden Co.*, 308 U.S. 188 (1939); *United States v. Rosenwasser*, 145 F.2d 1015 (C.A. 9, 1944); *United States v. Socony Mobil Oil Company*, 252 F.2d 420 (C.A. 1, 1958). There is no provision in that Act for an appeal from an order suspending sentence and granting probation, or from the denial of a motion to correct sentence.

The fact that there is no right of appeal by the Government does not preclude the issuance of a writ of mandamus as an exercise of appellate jurisdiction. In *United States v. United States District Court for the Southern District of New York*, 334 U.S. 258, 263 (1947), the Court stated:

It was early recognized that the power to issue a mandamus extended to cases where its issuance was either an exercise of appellate jurisdiction or in aid of appellate jurisdiction. * * * That power protects the appellate jurisdiction which might be otherwise defeated and extends to support an ultimate power of review, though it not be immediately and directly involved. * * *

But the fact that mandamus is clearly connected with the appellate power does not necessarily mean that the power to issue it is absent where there is no existing or future appellate jurisdiction to which it can relate. * * *

STATEMENT OF THE CASE

On May 27, 1958, at San Diego, California, an information was filed pursuant to waiver of indictment executed by each defendant, charging Robert

Emil Austin, age 19, and Albert F. Smithson, Jr., age 19 (as of July, 1958), with a violation of Title 21, United States Code, section 176(a) (smuggling of marihuana). Both defendants pleaded guilty, and on June 16, 1958, Judge Carter, acting pursuant to the provisions of the Youth Corrections Act, 18 U.S.C. 5010(a), suspended the sentences and placed the defendants on probation for a period of five years. Copies of the information and of the Judge's order finding the defendants guilty but suspending sentence and placing them on probation are annexed in the appendix to this brief, marked Exhibits "A", "B", and "C", respectively.²

On November 24, 1958, at San Diego, California, an information was filed pursuant to a waiver of indictment executed by the defendant, charging Jean Helen Feaux, age 19, with a violation of Title 21, United States Code, section 174 (illegal importation of narcotics). Miss Feaux entered a plea of guilty, and on March 30, 1959, Judge Carter found her guilty and suspended sentence, placing her on probation for five years, again citing the Youth Corrections Act as his authority. Copies of the information and the Judge's order are annexed in the appendix to this petition, marked Exhibits "D", and "E", respectively.

In both cases the Government filed motions to correct sentence. Judge Carter denied the motions in orders handed down March 30, 1959. Copies of the order, as well as of Points and Authorities in

² One set of certified copies of each of the exhibits "A" through "K" is being filed in this action with the Petition.

Opposition to the Motion to Set Aside the Judgment and Correct an Illegal Sentence, filed by defendant Austin (defendant Smithson filed no written opposition); of Points and Authorities in Support of Application for Probation Under the Youth Corrections Act, filed by defendant Feaux; and of Notice of Opposition to Defendant's Request for Probation and supporting memorandum, filed by the Government, are annexed in the appendix to this brief, marked Exhibits "F", "G", "H", "J", and "K", respectively.

ARGUMENT

I

Under The All Writs Act This Court Has the Power to Supervise the Exercise of Jurisdiction of Courts Within Its Appellate Jurisdiction by a Writ of Mandamus.

The issuance of the writ of mandamus in these cases is sought under the authority of the "All Writs Act". The power of the Court of Appeals to grant these writs under the Act to review orders of lower courts was recognized by the Supreme Court in *La Buy v. Howes Leather Co.*, 352 U.S. 249 (1956). In that case, the Court affirmed the use of mandamus by the Court of Appeals to prevent a District Judge from referring a lengthy antitrust case to a master to relieve his crowded docket. The Court found that the complexity of the case compelled the use of a trial, that a master might be used only to fix damages after the court had determined the overall liability of defendants, and that therefore the Court of Appeals was correct in granting the writ of mandamus. "We believe that supervisory control of the

District Courts by the Courts of Appeals is necessary to proper judicial administration in the federal system." 352 U.S. at 259-260. The rule of the *La Buy* case is especially applicable to the instant problem, for the case here involves not merely an error in timing by a judge as to when he may submit an antitrust case to a master, but rather the refusal of the trial court to apply the clear terms of a statute. The writ may of course issue to confine an inferior court to a lawful exercise of its prescribed jurisdiction (*Roche v. Evaporated Milk Assn.*, 319 U.S. 21 (1942)) and its use for that purpose is discretionary with the appellate court. *La Buy*, *supra*.³

An example of the use of mandamus to correct errors such as those in these two cases may be found in *Ex parte United States*, 242 U.S. 27 (1916) where the Court granted the writ to set aside an order of the trial court suspending sentence in an embezzlement case when the mandatory minimum sentence was five years. Speaking of the obligation of the court to sentence, the Court said (242 U.S. at 42):

. . . if it be that the plain legislative command fixing a specific punishment for crime is subject to be permanently set aside by an implied judi-

³ The Court also specified in *La Buy* that the writ was to be "in aid of jurisdiction". *Ibid.*, p. 255. In one of the early cases involving the use of the writ of mandamus, Chief Justice Marshall supplied a guide for defining these terms: "A mandamus to an officer is held to be the exercise of original jurisdiction; but a mandamus to an inferior court of the United States is in the nature of appellate jurisdiction." *Ex parte Crane*, 5 Peters 190, 193 (1831). See also, *United States v. United States District Court for the Southern District of New York*, *supra*.

cial power upon considerations extraneous to the legality of the conviction, it would seem necessarily to follow that there could be likewise implied a discretionary authority to permanently refuse to try a criminal charge because of the conclusion that a particular act made criminal by law ought not to be treated as criminal. And thus it would come to pass that the possession by the judicial department of power to permanently refuse to enforce a law would result in the destruction of the conceded powers of the other departments and hence leave no law to be enforced.

With respect specifically to an unlawful exercise of jurisdiction, see *United States v. Albrecht*, 25 F.2d 93 (C.A. 7, 1928); and see also, *United States v. Akerman*, 61 F.2d 570 (C.A. 5, 1932).

II

The Youth Corrections Act Does Not Contain a New Grant of Power to Suspend Sentence and Place an Offender on Probation.

As his authority to suspend sentence and grant probation in these cases, Judge Carter specifically relied on section 5010(a) of Title 18, United States Code, which provides as follows:

(a) If the court is of the opinion that the youth offender does not need commitment, it may suspend the imposition or execution of sentence and place the youth offender on probation.

Read in a vacuum, this part of the statute would seem to indicate that the Youth Corrections Act confers plenary power to suspend sentence and to grant probation. However, section 5023(a) of the same

Act, which of course must be read in *pari materia*, provides:

Nothing in this chapter shall limit or *affect* the power of any court to suspend the imposition or execution of any sentence and place a youth offender on probation or be construed in any wise to *amend, repeal, or affect* the provisions of chapter 231 of this title relative to probation (emphasis added).

Section 5023(a) makes it clear that section 5010(a) does not give the trial court any new or additional power to grant probation—it merely perpetuates in the Youth Corrections Act whatever power to grant probation exists elsewhere. Section 5010(a) is in line with the Congressional purpose that the new methods of treatment of youth offenders be merely optional, and that the courts should be free to continue to use certain established means, including probation, of dealing with these offenders.

This conclusion is strengthened by the Report of the Committee on the Judiciary to accompany S. 2609—which later became the Youth Corrections Act—(House Report No. 2979, 81st Cong., 2d Sess., p. 3):

The problem is to provide a successful method and means for treatment of young men between the ages of 16 and 22 who stand convicted in our Federal courts and are not fit subjects for supervised probation—a method and means that will effect rehabilitation and restore normality, rather than develop recidivists . . .

Under its (S. 2609) provisions, if the court finds that a youth offender does not need treat-

ment, it may suspend the imposition or execution of sentence and place the youth offender on probation. *Thus, the power of the court to grant probation is left undisturbed by the bill* (emphasis added).

Accordingly, the solution to the problem of whether, in a given case, a youth offender may be given probation will not be found in the Youth Corrections Act, but elsewhere; that is, in the statutes dealing specifically with probation as applied to specific offenses. If a statute either permits or prohibits the grant of probation with respect to a type of offense, then such statutory provision is not "affected" (18 U.S.C. 5023 (a)) and is left "undisturbed" (H.Rept. 2979) by the Youth Corrections Act.⁴

⁴ In his opinion denying the Government's motions (Exhibit L, appendix), Judge Carter was concerned about the fact that Public Law 85-752 (85th Cong., 2d Sess.), which extended the treatment provisions of the Youth Corrections Act to offenders between the ages of 22 and 26, contained the following language in its section 7:

This Act does not apply to any offense for which there is provided a mandatory penalty.

Judge Carter seemed to feel that if Congress had intended that any part of the Youth Corrections Act which covered offenders under the age of 22 should not apply where there is a mandatory penalty, it would have said so.

It must be remembered that the *treatment* provisions (18 U.S.C. 5010 (b), (c)) are the essential part of the Youth Corrections Act. It is these provisions which Congress denied to those offenders between the ages of 22 and 26 who are subject to a mandatory penalty, while it did not deny those provisions to offenders under the age of 22. But this does not affect the probation power.

III

The Narcotics Control Act of 1956 Specifically Prohibits the Suspension of Sentence and Granting of Probation in These Cases.

Title 26, United States Code, Section 7237 (d) provides:

Upon conviction (1) of any offense the penalty for which is provided in subsection (b) of this section, subsection (c), (h), or (i) of section 2 of the Narcotic Drugs Import and Export Act, as amended, or such Act of July 11, 1941, as amended, or (2) of any offense the penalty for which is provided in subsection (a) of this section, if it is the offender's second or subsequent offense, the imposition or execution of sentence shall not be suspended, probation shall not be granted, section 4202 of title 18 of the United States Code shall not apply, and the Act of July 15, 1932 (47 Stat. 696; D.C. Code 24-201 and following), as amended, shall not apply.

The offenses of which the defendants were convicted—21 U.S.C. 174 and 176(a)—are subsections (c) and (h) of section 2 of the Narcotic Drugs Import and Export Act, as amended, referred to in 7237 (d) above.

It is apparent not only that Congress clearly intended that the prohibitions of section 7237 (d) should apply to both adult and youthful first-offenders, but that this section was especially directed at the youthful offender. A typical comment is found in House Report No. 2388 of the Committee on Ways and Means to accompany H.R. 11619 (at p. 64):

. . . We have adduced substantial evidence that because of the severe penalties on repeating of-

fenders and the fact that suspension and probation are not available in the case of an individual with a record of prior narcotic convictions there has been an increase in first offender traffickers. Repeating offenders subject to the heavier mandatory penalties under the Boggs law have moved into the background and recruited *young* hoodlums as peddlers in the narcotic traffic. These recruits are subject to the minimum mandatory sentence of 2 years with the possibility of suspension or probation . . . The majority of these individuals have prior records of crime . . . With the possibility of receiving probation or a suspended sentence, these unscrupulous individuals are willing to risk apprehension for the fantastic profits derived from this type of crime . . . Unless immediate action is taken to prohibit probation or suspension of sentence, it is the subcommittee's considered opinion that the first-offender peddler problem will become progressively worse and eventually lead to the large-scale recruiting of our *youth* by the upper echelon of traffickers (emphasis added).

The Youth Corrections Act was passed in 1950, the Narcotics Control Act in 1956. Since it is the later in point of time, the Narcotics Act should be considered as controlling in its effect on issues in common between the two statutes. *United States v. Yugonovich*, 256 U.S. 450, 463 (1920). Congress first gave the courts the power to grant probation in 1925. The Youth Corrections Act recognized the existence of this power in general terms, making it clear that it was not changing the power of the courts to use this device in lieu of the provisions of the Act. Thereafter, the Narcotics Control Act specifically re-

voked a portion of this power with respect to probation. Under applicable principles of statutory construction, the specific mention in the Narcotics Act of the matter of probation in the case of narcotics offenders must, of course, prevail over the general treatment of all types of offenses in the Youth Corrections Act. *MacEvoy Co. v. United States*, 322 U.S. 102, 107 (1943); *United States v. Gross*, 159 F. Supp. 316, 318 (D. Nev. 1958).

IV

The Youth Corrections Act May Still Be Used to Effect Rehabilitation and Treatment of These Offenders.

The Youth Corrections Act provides the court with the means to alleviate any situation in which either the law or the facts require that the severity of the narcotics laws be tempered with an effort at rehabilitation. Section 5010(b) of 18 U.S.C. provides as follows:

If the court shall find that a convicted person is a youth offender, and the offense is punishable by imprisonment under applicable provisions of law other than this subsection, the court may, in lieu of the penalty of imprisonment otherwise provided by law, sentence the youth offender to the custody of the Attorney General, for treatment and supervision pursuant to this chapter until discharged by the Division as provided in section 5017 (c) of this chapter.

The "treatment and supervision" would include observation, study, and classification at an appropriate center or agency (section 5010 d); treatment at "training schools, hospitals, farms, forestry and other

camp, and other agencies that will provide the essential varieties of treatment" (section 5011). It might also include a recommendation that the committed youth offenders be "released conditionally under supervision" (section 5015), which could result in unconditional release within a year, depending on the progress made (section 5017). Should these youthful offenders be thus unconditionally released prior to the expiration of the maximum sentence imposed on them, they would be entitled to have their conviction automatically set aside and a certificate issued to that effect (section 5021). It is apparent that adoption of the construction advocated herein will not result in the imposition of the mandatory narcotics sentences on all youth offenders. The treatment provisions of section 5010(b) may be invoked by the sentencing court in any case in which leniency appears warranted.

CONCLUSION

This writ of mandamus is sought as the only means available to compel Judge Carter to exercise the judicial discretion entrusted to him in accordance with the specific directive of the Narcotics Act. It is respectfully requested that the writ issue.

W. WILSON WHITE,
Assistant Attorney General.

LAUGHLIN E. WATERS,
United States Attorney.

HAROLD H. GREENE,
GERALD P. CHOPPIN,
Attorneys.

APPENDIX

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EXHIBIT A

IN THE UNITED STATES DISTRICT COURT
IN AND FOR THE SOUTHERN DISTRICT OF CALIFORNIA
SOUTHERN DIVISION

No. 27584-SD

INFORMATION

(U.S.C., Title 21, Sec. 176(a)-
Smuggling of Marihuana)

UNITED STATES OF AMERICA, PLAINTIFF,

vs.

ALBERT EDWARD SMITHSON, JR., ROBERT EMIL
AUSTIN, DEFENDANTS.

The United States Attorney charges:

On or about May 18, 1958, in San Diego County, within the Southern Division of the Southern District of California, defendants ALBERT EDWARD SMITHSON, Jr., and ROBERT EMIL AUSTIN, with intent to defraud the United States, did knowingly smuggle and clandestinely introduce into the United States from a foreign country, namely, Mexico, approximately two pounds, net weight, of bulk marihuana, which should have been invoiced, and did knowingly import and bring into the United States from a foreign country, namely, Mexico, said marihuana contrary to law, in that said marihuana had not been presented for inspection, entered, and declared and provided by United States Code, Title 19, Sections 1461, 1484 and 1485.

LAUGHLIN E. WATERS
United States Attorney

PETER J. HUGHES
Assistant United States Attorney

EXHIBIT B

Judgment and Commitment (Rev. 7-52)

UNITED STATES DISTRICT COURT
FOR THE
SOUTHERN DISTRICT OF CALIFORNIA,
SOUTHERN DIVISION

No. 27584-Crim.

UNITED STATES OF AMERICA

v.

ALBERT EDWARD SMITHSON, JR.

On this 16th day of June, 1958 came the attorney for the government and the defendant appeared in person and ¹ by counsel, Barton Sheela

IT IS ADJUDGED that the defendant has been convicted upon his plea of ² guilty of the offense of smuggling of marihuana in violation of U.S.C. Title 21, Section 176(a) as charged ³ in the Information in one count and the court having asked the defendant whether he has anything to say why judgment should not be pronounced, and no sufficient cause to the contrary being shown or appearing to the Court,

IT IS ADJUDGED that the defendant is guilty as charged and convicted.

IT IS ADJUDGED that the defendant is eighteen (18) years of age and is a youth offender. Pursuant to United States Code, Title 18 Section 5010 (a) and in lieu of the penalty of imprisonment otherwise pro-

vided by law for the offense of which the defendant is convicted,

IT IS ADJUDGED that the imposition of sentence is suspended and the defendant is placed on probation for a period of five years on condition that he obey all laws, Federal, State and Municipal, that he comply with all lawful rules and regulations of the Probation Department, report regularly and keep them advised of his residence, and employment, that he does not use or associate with known users of or dealers in barbiturates, marihuana, or narcotics in any form, and that he does not enter Mexico nor approach the Mexican Border without permission from the Probation Department, and that he get a job and maintain regular employment.

JAMES M. CARTER,
United States District Judge.

Filed June 16, 1958 JOHN A. CHILDRESS, *Clerk*

By WILLIAM W. LUDDY, *Deputy Clerk.*

A True Copy Certified this 16th day of June, 1958
(Signed) JOHN A. CHILDRESS, *Clerk* (By) WILLIAM
W. LUDDY, *Deputy Clerk.*

EXHIBIT C

Judgment and Commitment (Rev. 7-52)

UNITED STATES DISTRICT COURT
FOR THE
SOUTHERN DISTRICT OF CALIFORNIA,
SOUTHERN DIVISION

No. 27584

UNITED STATES OF AMERICA

v.

ROBERT EMIL AUSTIN

On this 16th day of June, 1958 came the attorney for the government and the defendant appeared in person and ¹ by counsel, Marvin Mizeur

IT IS ADJUDGED that the defendant has been convicted upon his plea of ² guilty of the offense of smuggling of marihuana in violation of U.S.C., Title 21, Section 176(a) as charged ³ in the Information in one count and the court having asked the defendant whether he has anything to say why judgment should not be pronounced, and no sufficient cause to the contrary being shown or appearing to the Court,

IT IS ADJUDGED that the defendant is guilty as charged and convicted.

IT IS ADJUDGED that the defendant is eighteen (18) years of age and is a youth offender. Pursuant to United States Code, Title 18 Section 5010 (a) and in lieu of the penalty of imprisonment otherwise pro-

vided by law for the offense of which the defendant is convicted,

IT IS ADJUDGED that the imposition of sentence is suspended and the defendant is placed on probation for a period of five years on condition that he obey all laws, Federal, State and Municipal, that he comply with all lawful rules and regulations of the Probation Department, report regularly and keep them advised of his residence, and employment, that he does not use or associate with known users of or dealers in barbiturates, marihuana or narcotics in any form, and that he does not enter Mexico nor approach the Mexican Border without permission from the Probation Department, and that he avail himself of the offer of Mr. Simmons and go to the ranch and follow gainful employment there unless he goes to school in which event he shall attend regularly.

JAMES M. CARTER,
United States District Judge.

Filed June 16, 1958 JOHN A. CHILDRESS, *Clerk*

By WILLIAM W. LUDDY, *Deputy Clerk.*

A True Copy Certified this 16th day of June, 1958
(Signed) JOHN A. CHILDRESS, *Clerk* (By) WILLIAM
W. LUDDY, *Deputy Clerk.*

EXHIBIT D

IN THE UNITED STATES DISTRICT COURT
IN AND FOR THE SOUTHERN DISTRICT OF CALIFORNIA
SOUTHERN DIVISION

No. _____SD Cr

INFORMATION

(U.S.C., Title 21, Sec. 174—
Illegal importation of narcotics)

UNITED STATES OF AMERICA, PLAINTIFF,

-vs-

JEAN HELEN FEAUX, DEFENDANT.

The United States Attorney charges:

On or about November 17, 1958, in San Diego County, within the Southern Division of the Southern District of California, defendant JEAN HELEN FEAUX, did knowingly import and bring into the United States of America from a foreign country; namely, Mexico, a certain narcotic drug; namely, twenty-four grains, net weight, of Heroin, contrary to law.

LAUGHLIN E. WATERS
United States Attorney

PETER J. HUGHES
Assistant United States Attorney

EXHIBIT E

Judgment and Commitment (Rev. 7-52)

UNITED STATES DISTRICT COURT
FOR THE
SOUTHERN DISTRICT OF CALIFORNIA,
SOUTHERN DIVISION

No. 28036-Criminal

UNITED STATES OF AMERICA

v.

JEAN HELEN FEAUX

On this 30th day of March, 1959 came the attorney for the government and the defendant appeared in person and ¹ by counsel, Harry D. Stewart

IT IS ADJUDGED that the defendant has been convicted upon her plea of ² guilty of the offense of illegal importation of narcotics, in violation of U. S. C., Title 21, Section 174, as charged ³ in the Information in one count, and the court having asked the defendant whether she has anything to say why judgment should not be pronounced, and no sufficient cause to the contrary being shown or appearing to the Court,

IT IS ADJUDGED that the defendant is guilty as charged and convicted.

IT IS ADJUDGED that the defendant is 19 years of age and is a youth offender. Pursuant to United

States Code, Title 18, Section 5010 (a) and in lieu of the penalty of imprisonment otherwise provided by law for the offense of which the defendant is convicted, imposition of sentence is suspended and the defendant is placed on probation for the period of five years on condition that she, either at her own expense or expense of her family, continue the treatment offered by Dr. Lengyel, or such other doctor he may recommend, until such time the doctor feels no further treatment is necessary. It is recommended that said treatment continue for at least one year.

IT IS ORDERED that periodical reports be submitted to the Probation Department showing the progress of the defendant, said reports to be submitted as may be determined by the Probation Department.

JAMES M. CARTER,
United States District Judge.

Filed March 30, 1959 JOHN A. CHILDRESS, *Clerk*
By WILLIAM W. LUDDY, *Deputy Clerk.*

A True Copy. Certified this 30th day of March
(Signed) JOHN A. CHILDRESS, *Clerk* (By) WILLIAM
W. LUDDY, *Deputy Clerk.*

EXHIBIT F

IN THE UNITED STATES DISTRICT COURT
IN AND FOR THE SOUTHERN DISTRICT OF CALIFORNIA
SOUTHERN DIVISION

No. 27584-SD Cr

UNITED STATES OF AMERICA, PLAINTIFF,

-VS-

ALBERT EDWARD SMITHSON, JR.; ROBERT EMIL
AUSTIN, DEFENDANTS.

ORDER

The above-entitled cause having come on for hearing, pursuant to a motion filed by the Plaintiff to correct the sentence imposed on June 16, 1958, as having been illegal, briefs having been submitted by both the plaintiff and defendant AUSTIN, the Court having heard oral argument and being fully advised in the premises,

IT IS HEREBY ORDERED that the motion by the United States to correct the sentences of SMITHSON and AUSTIN is denied.

This 30th day of March, 1959.

/s/ James M. Carter
United States District Judge

Approved as to form only:

Marvin J. Mizeur

Barton C. Sheela, Jr.

EXHIBIT G

IN THE UNITED STATES DISTRICT COURT
IN AND FOR THE SOUTHERN DISTRICT OF CALIFORNIA
SOUTHERN DIVISION

No. 28036-SD Cr

UNITED STATES OF AMERICA, PLAINTIFF,

-vs-

JEAN HELEN FEAUX, DEFENDANT.

ORDER

The Defendant in the above-entitled cause having come before the Court on March 30, 1959, for sentence, the Court having found that the defendant is nineteen years of age and would benefit from treatment under the Youth Corrections Act, imposition of sentence having been suspended and the defendant placed on probation for a period of five years pursuant to the provisions of Title 18, Section 5010(a), and Assistant United States Attorney Peter J. Hughes having moved the Court to correct the sentence as being illegal,

IT IS HEREBY ORDERED that said motion by the United States is denied.

This 30th day of March, 1959.

/s/ James M. Carter
United States District Judge

Approved as to form:

Harry D. Steward

EXHIBIT H

MARVIN J. MIZEUR
Attorney at Law
357 Spreckels Building
San Diego 1, California
Belmont 3-8941

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA
SOUTHERN DIVISION

No. 27584-SD CR

UNITED STATES OF AMERICA, PLAINTIFF,

VS.

ROBERT EMIL AUSTIN and ALBERT EDWARD
SMITHSON, JR., DEFENDANTS,

POINTS AND AUTHORITIES IN OPPOSITION
TO THE MOTION TO SET ASIDE THE JUDG-
MENT AND CORRECT AN ILLEGAL SEN-
TENCE *

The real issue for the Court to determine in this matter appears to be whether or not the Narcotics Control Act of 1956 repealed the Youth Corrections Act of 1950. The defendant, Robert Emil Austin contends that the Narcotics Control Act of 1956 did not repeal the Youth Corrections Act of 1950, and Congress neither stated nor did they intend that such Youth Corrections Act be repealed by the Narcotics Control Act of 1956.

In Cunningham vs U.S., 256 Fed 2d 467 at Page

* These Points and Authorities were the only pleading filed by Austin and Smithson.

471, in footnote 4, quoting Chief Judge Phillips, during hearings before a Sub-Committee of the Senate Judiciary Committee on a "Correctional System for Youth Offenders" 81st Congress, First Session, he stated as follows:

"As stated in the House Report, the statute (Youth Corrections Act) is designed to make available for the discretionary use of the Federal Judges the system for sentencing and treatment of youth offenders that would promote the rehabilitation of those who show promise of becoming useful citizens and so will avoid the degenerative and needless transformation of many of those persons into habitual criminals. . . . It marks a departure from the punitive idea of dealing with criminals and looks to the objective idea of rehabilitation."

The Youth Corrections Act borrows from the Youth Authority Statutes in California, Minnesota, Wisconsin, Massachusetts and Texas, and from a model act proposed by the American Law Institute in 1941.

In a California case entitled in RE Berrera, 23 Cal 2d 206 at Page 213, the Court in commenting on the reasonableness in the classification of those who may be sent to the Youth Authorities stated:

"The great value in the treatment of youth offenders lies in its timeliness in striking at the roots of recidivism. Reaching the offender during his formative years, it can be an impressive bulwark against the confirmed criminality that defies rehabilitation, for it is characteristic of youth to be responsive to good influence as it is susceptible to bad.

The California case and the House Report indicates the purposes behind the Legislature and the Congress

in enacting the Youth Corrections Acts. It becomes clear that they did intend and did in fact make a separate and distinct classification and a separate and distinct manner of handling youth offenders, if in the opinion of the Judge sitting on the case, it was to the advantage and benefit of the youth to be given the advantage of the measures available under the Youth Corrections Act and the Youth Authority Acts.

In the case of *Cunningham vs. U.S.*, the Court stated, among other things, that the Youth Correction Act is based upon modern and improved penological views and methods of affording youthful offenders, in the discretion of the Judge, opportunity to escape from the physical and psychological shocks attendant upon serving an ordinary penal sentence, and Congress could make general distinction between treatment of persons over, and those under, 22 years of age.

In Title 18 USC 5010(a), the code states:

“If the Court is of the opinion that the youth offender does not need commitment, it may suspend the imposition or execution of sentence, and place the youth offender on probation.”

The above is a part of the Youth Corrections Act of 1950. The Narcotics Control Act of 1956 is silent as to the effect it has upon the Youth Correction Acts. At a glance in the code it will become evident, that when Congress intends to affect by new legislation, some older legislation, it makes reference to that fact in the enactment. By way of example, in 26 Sec. 7237B, Sub Sec. 2 of the Internal Revenue Code, that section states, among other things, that the imposition or execution of sentence shall not be suspended (upon conviction of designated offense) probation shall not be granted, Section 4202 of Title 18 USC shall not

apply and etc. Without quoting, but by reference only, Title 18 Sec. 5026 again specifies the intent of Congress as to whether or not the new enactment shall affect related laws or activities. This is just a few examples of legislation or enactments by Congress, wherein they specifically state when other and older enactments shall be affected by new legislation. It is an old axiom of statutory construction that repeals by implication are not favored. No where in the Narcotics Control Act of 1956 does there appear a statement directly or by inference, that Congress intended that the Youth Corrections Act be repealed in part or in total, by the said Narcotics Control Act of 1956. The Courts' attention is also called to the fact that Congress in enacting 18 U S C 4209 (An act authorizing the use of Youth Corrections Act for those from ages 22-26) did state that said code section would not be applicable to any offense for which there is provided a mandatory penalty, but Congress was silent as to the effect that this section would have upon youths from the age of 18 to 22.

It is the contention of the defendant Robert Austin that Congress, in enacting the legislation states what they mean, and when they are silent on any given matter, it is not to be implied that they intend to repeal by implication.

The defendant Robert Austin also respectively submits to this Court the suggestion that the Attorney Generals' office may have not considered thoroughly their actions in this type of proceeding before they sent out their orders to the various districts. That what they term to be illegal sentences, must be corrected. It is the defendants belief that had further consideration been given, the Attorney Generals' office would have considered the fact that the present order and the present motion before the Court can do

irreparable harm to the youth offenders who have previously been before this Court, and have been considered by this Court to be proper probationary subjects. The defendant Robert Austin, respectively submits that he has been on probation, under this Courts' order for nine (9) months, and has rehabilitated in a proper manner and has complied substantially with the requests of the Probation Department and with the order of the Court. It is respectively submitted that more attention should be given by the Attorney Generals' office to their present request. It is believed that a more proper approach to the present problem would be to make an order to the various districts effective as of the time the order is given, in regard to future sentencing and probation requests, if it is the conviction of the U S Attorney Generals' office, that probation cannot be granted under the violations to which the defendant Robert Austin pleaded, namely USC 21, Sec. 176(a).

The defendant, Robert Austin respectively requests the Court to deny the motion of the U S Attorneys' office to have the previous sentence and probationary term set aside.

Respectively submitted

Attorney for Defendant
Robert Austin

EXHIBIT J

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA
SOUTHERN DIVISION

No. 28,036 - Criminal

UNITED STATES OF AMERICA, PLAINTIFF,

vs.

JEAN HELEN FEAUX, DEFENDANT.

POINTS AND AUTHORITIES IN SUPPORT OF
APPLICATION FOR PROBATION UNDER THE
YOUTH CORRECTIONS ACT *

The government contends, and the defendant concedes, that the Narcotics Control Act of 1956 suspended the operation of Chapter 231 of Title 18 (Probation, Sections 3651, et seq.) as to defendants who were convicted of certain narcotic offenses including Section 174 of Title 21 United States Code. It is submitted that the real question for the court to determine is whether or not the Narcotics Control Act of 1956 repealed the Youth Corrections Act of 1950 as to all of those so convicted. It is the defendant's position that Congress did not intend to, and in fact did not, repeal the Youth Corrections Act.

* These Points and Authorities were the only pleading filed by Jean Feaux.

The Youth Corrections Act was under study for some ten years prior to its enactment in 1950.

As stated in the House Report, the statute is designed to make available for the discretionary use of the Federal Judges a system for the sentencing and treatment of youth offenders that will promote the rehabilitation of those who show promise of becoming useful citizens and so will avoid the degenerative and needless transformation of many of those persons into habitual criminals. To that end, it provides for a system of analysis, treatment, and release that will cure, rather than accentuate the anti-social tendencies that have led to the commission of crime. This is done by permitting the substitution of correctional rehabilitation for retributive punishment. It marks a departure from the punitive idea of dealing with criminals and looks primarily to the objective idea of rehabilitation. House Report No. 2979, 81st Congress, Second Session, Page 1.

In these aims, the Act is based upon principles and procedures developed under what has become known as the Borstal System, which has been in successful operation in England since 1894. It also borrows from Youth Authority Statutes in California, Minnesota, Wisconsin, Massachusetts and Texas, and from a model act proposed by the American Law Institute in 1941.

It is clear that Congress intended to, and in fact did, establish a separate and distinct method and manner of treating those youth who were convicted of offenses between the ages of 18 and 22. See *Cunningham vs. U. S.*, 256 Fed 2d 467 at Page 471, wherein it is stated:

As pointed out in the Government's brief, the Youth Corrections Act applies to convicted persons under the age of 22 years at the time of the conviction and is designed to provide such persons with correctional treatment looking to their complete rehabilitation in lieu of punishment, that is with preventive guidance and training, and *all of its provisions* are designed, enacted and enforced with that end in view. (Emphasis added).

The court further stated in the *Cunningham* case, at Page 473, as follows:

While appellant does not here invoke, as indeed he cannot, the protection clause of the Fourteenth Amendment, against the classification of which he complains, it has been definitely settled by the decisions of state courts in states which have such laws and in general by the decision of the Supreme Court of the United States in *State of Minnesota ex rel. Pearson vs. Probate Court*, 309 U. S. 270, that classifications of the general nature of that involved here are not invalid. These and other cases uniformly hold that: while arbitrary or unreasonable classifications may not be set up, there must be differences in character, condition or situation to justify the distinction; that the distinctions and differences in short must bear a due and proper relation to the classification; the equal protection of the law is afforded if the law in question operates in the same general way on all who belong in the same class. For the same reasons, it will not avail appellant under this record to claim under *Bolling vs. Sharpe*, 347 U. S. 497, that the due process secured by the Fifth Amendment has been in any way denied him.

The Cunningham decision is very persuasive on the question of whether Congress intended to, and in fact did, establish a separate and distinct method and procedure of dealing with youth. In that case the defendant, in proper, entered a plea of guilty to theft of a radio of a value less than \$100.00. This was a misdemeanor charge with a maximum imprisonment of one year. The court, however, found that the defendant was a youth offender and committed him to the custody of the Attorney General pursuant to the provisions of Youth Corrections Act. One year later, the defendant filed a writ of habeas corpus contending that, among other things, he could not be incarcerated for any period longer than the maximum one year provided on the misdemeanor charge. The Fifth Circuit, speaking through Chief Judge Hutcheson, denied the writ of habeas corpus on the general grounds that the Youth Corrections Act controlled rather than the specific charge.

It is understood that the government concedes that 18 U. S. C. 5010(b) (c) may be used by the court in imposing sentence. It is understood that the government's present position is that only Paragraph (a) of 18 USC 5010 is not applicable due to the enactment of the Narcotics Control Act of 1956. It is the defendant's position that the Federal Youth Corrections Act must be considered as standing alone insofar as sentencing provisions and the like are concerned. In enacting the Youth Corrections Act, additional powers were vested in the court in connection with the type of sentence that might be imposed. In fact, the provisions of the Youth Corrections Act are different from the other provisions in the Codes pertaining to punishment.

By way of example, a youth of 19 convicted of a violation of the Dyer Act, can be granted probation

or can be committed for any period that the court might determine up to a maximum of five years. The commitment would be under 18 USC 2312 and the probation would be under 18 USC 3651, et seq. This would be the situation prior to 1950. However, since 1950 the court has still another new and different method to sentence a 19 year old youth convicted of the Dyer Act. The new method is set forth in the Youth Corrections Act and authorizes the court to place the defendant on probation pursuant to the Youth Corrections Act or commit him pursuant to the same Act (18 USC 5010(b), et seq.). Once a defendant has been found by the court to be a youth offender within the meaning of the Act, then the Youth Corrections Act controls. In the hypothetical example, if the 19 year old defendant is placed on probation under the general probationary sections, and thereafter violates his probation, the court of necessity must impose sentence pursuant to 18 USC 2312. However, if the court has found that the 19 year old is a youth offender and places him on probation pursuant to the Youth Correction Act, and he thereafter violates his probation, then the court may impose sentence only pursuant to the Youth Corrections Act and may not revert to 18 USC 2312. *Cunningham vs. United States*, 256 Fed 2d 467.

Congress must have intended to create a new and different type of probationary sentence when it included same within the Youth Corrections Act, or the reference to probation in the sentence section would be superfluous. As further indication of Congressional intent, the court's attention is respectfully directed to 18 USC 5023, which states:

Nothing in this chapter shall limit or affect the power of any court to suspend the imposition or execution of any sentence and place the youth

offender on probation or be construed in any wise to amend, repeal or affect the provisions of Chapter 231 of this Title; (Probation).

It would appear that this means that the court, under appropriate circumstances, could place a 19 year old defendant under probation pursuant to the general probationary sections or the Youth Corrections Act, whichever appeared to be more appropriate.

One of the canons of statutory construction is that repeals by implication are not favored. If the Youth Corrections Act has been repealed by the Narcotics Control Act of 1956, the repeal must have been by implication, as there has never been a clear cut statement of Congress stating that the Youth Corrections Act is no longer applicable.

Congress has, however, stated, in 1958, that 18 USC 4209 (authorizing the use of the Youth Corrections Act for those from ages 22-26) would not be applicable to any offense for which there is provided a mandatory penalty. (Section 7, Public Law 85-752; 72 Stat. 845; Approved Aug 25, 1958). But no mention was made of youths from ages 18 to 22.

Expressio Unius Est Exclusio Alterius.

Congress could have specifically stated that the Youth Corrections Act was not subject to an offense where there was a mandatory penalty. This they have not done. Accordingly, it is respectfully submitted that Congress did not intend to and in fact did not repeal the effect and operation of the Youth Corrections Act in any manner by the enactment of the Narcotics Control Act of 1956.

Respectfully submitted,

HARRY D. STEWARD
Attorneys for Defendant

EXHIBIT K

IN THE UNITED STATES DISTRICT COURT
IN AND FOR THE SOUTHERN DISTRICT OF CALIFORNIA
SOUTHERN DIVISION

No. 28036-SD Cr

UNITED STATES OF AMERICA, PLAINTIFF,

-VS-

JEAN HELEN FEAUX, DEFENDANT.

NOTICE OF OPPOSITION TO DEFENDANT'S
REQUEST FOR PROBATION

Comes now the UNITED STATES OF AMERICA, Plaintiff in the above-entitled cause, by and through its counsel herein, and in addition to the matters submitted on the merits of Defendant's request for probation opposes such request on the following ground:

The Court lacks jurisdiction to suspend execution of the sentence and place the Defendant on probation as a Youth Offender pursuant to the provision of Title 18, United States Code, Section 5010(a). This opposition is based on the records and files in the above-entitled cause and the Memorandum attached hereto.

Respectfully submitted,

LAUGHLIN E. WATERS
United States Attorney

ROBERT JOHN JENSEN
Assistant United States Attorney
Chief, Criminal Division

PETER J. HUGHES
Assistant United States Attorney

MEMORANDUM

Defendant has entered a plea of guilty to a violation of Title 21, United States Code, Section 174; more specifically, to having imported and brought into the United States from Mexico twenty-four grains of Heroin. Section 174 of Title 21 is also identified as sub section c of Section 2, Narcotic Drugs Import and Export Act, as amended, which provides that upon a conviction Defendant shall be imprisoned for a period of not less than five or more than twenty years for a first offense. Section 7237 (d) of Title 26, as amended by the Narcotics Control Act of 1956, provides that upon a conviction for violating sub section c, Section 2, Narcotic Drugs Import and Export Act, as amended: "the imposition or execution of sentence shall not be suspended, probation shall not be granted, . . ." It should be noted that the defendant has plead guilty to a charge of trafficking in narcotics, not simply to possessing narcotics. The legislative hearings which preceded enactment of the Narcotic Control Act of 1956 contains the following: "There would be a prohibition on the granting of probation, suspension of sentence or parole with respect to any of the increased penalties applicable to *traffickers*. These mitigations of sentences would continue to be available in the case of first offender possessor." (H.R. No. 2388, June 19, 1956. USC and Cong. News, 1958, p. 3275; emphasis added). It is submitted that the prohibition against granting probation is also applicable to youth offenders. An examination of the Federal Youth Corrections Act indicates that this legislation added nothing to the powers already possessed by Federal Courts with respect to granting probation. The innovations brought into operation by the Youth Corrections Act are found in Title 18, Section 5010, paragraphs b, c

and e. It is submitted, however, that paragraph (a) of Section 5010 added nothing to the power already held by Federal Courts so far as granting of probation is concerned, and paragraph (a) simply was inserted to clarify the fact that the Youth Corrections Act did not negate the powers granted by Title 18, Section 3651 with respect to probation. Indeed, Section 5023(a) of Title 18 specifically provides: "Nothing in this chapter shall limit or affect the power of any Court to suspend the imposition or execution of any sentence and place a youth offender on probation *or be construed in any wise to amend, repeal or affect* the provisions of Chapter 31 of this Title. [Probation]."

The *sui generis* treatment by Congress of narcotic offenders was again emphasized when Section 4209 of Title 18 was enacted to permit treating defendants between the ages of 22 and 26 under the Youth Corrections Act. Congress, however, specifically provided that new Section 4209 would not be available where there was a mandatory penalty. (Sec. 7, Public Law 85-752; 72 Stat. 845; approved August 25, 1958.)

For the foregoing reasons it is respectfully submitted that the Court is without power to suspend execution of a sentence and place a youth offender on probation under paragraph (a), Section 5010 of Title 18, where such youth offender has been convicted of a violation of Title 21, United States Code, Section 174.

EXHIBIT L

Opinion of Judge Carter Denying Government's Motion to Correct Sentences

THE COURT: Well, I am going to decide the matter. I have read the briefs and I have listened to the arguments and have given it some thought. I haven't any real assurance that I am right. I am trying to separate in my thinking any sympathy I may have for these defendants by reason of the situation that they now find themselves in.

It seems to me that when Congress passed the Youth Corrections Act they set up a whole new system of sentencing in connection with youth offenders. It is true that probation had previously existed, but the statute included a provision on probation. If Congress had desired, they needn't have placed that section in there, unless it was in their thinking part of this plan for youthful offenders—there already was a probationary section. They added Section 5010(a), Section 5010(b), Section 5010(c), Section 5010(d), et cetera.

Now it is clear from the Cunningham case that this Youth Corrections Act cuts clear across the matter of sentencing. In the Cunningham case the defendant was sentenced to a longer time and he was doing a longer time than he would have been doing had he been sentenced under the regular statute. But because he was a youthful offender, it was felt that Congress had so changed the law—that although Congress said that he could do only a year for the particular offense, he got more than a year because he was treated as a youthful offender.

Now the Narcotics Control Act also cut across various existing statutes. It is interesting that in the Narcotics Control Act Congress specified in many

instances, if not in most, the particular sections that were being amended. All through that act you will find references to the particular sections that were being amended. There was no reference to the Youth Corrections Act. Now therefore, if Congress was attempting to cut down the scope of the Youth Corrections Act, it was doing it by implication or it was doing it inadvertently.

Then even more significant is the statute passed, which became effective in August, 1958, where there was set up the category of "Young adult offenders." It is true that Congress didn't make that section a part of the Youth Corrections Act, and as I have already commented they placed it in Chapter 311 of Title 18, the section on Parole, and the section immediately preceding it in the new Act, Section 4208, fixing eligibility for parole, obviously belonged there. They made this Section 4209 of Title 18, and they referred to a defendant who has attained his 22nd birthday but not his 26th. Now, obviously, they were thinking about the Youth Corrections Act, because that is the only place in the law where anybody has any significance attached to them because they are 22.

"If, after taking into consideration the previous record of the defendant . . . social background, capabilities, mental and physical health, and such other factors as would be considered pertinent, the court finds that there is reasonable grounds to believe that defendant will benefit from the treatment provided under the Federal Youth Corrections Act" (again they refer to that Act) "sentence may be imposed pursuant to the provisions of such Act."

So they were setting up a new category of young adult offenders, picking up at age 22 where the so-called youth offender stopped, and they provided that the sentence might be imposed pursuant to the provisions of that Act. And then they went ahead and said, "This Act . . ."—of course, that refers not to the Youth Corrections Act but to Public Law 85-752, but it is the act which set up this category of age 22 to 26—"This Act does not apply to any offense for which there is provided a mandatory penalty." So they had in mind what impact the statute would have on the problem of sentences under the Youth Corrections Act, and they provided that this would not apply where there was a mandatory penalty.

Now what they did is not unreasonable. There is a difference between the person who is between 18 and 22 and the person between 22 and 26. It is not unreasonable to assume that Congress intended that the two classes would be treated differently; that as to those between 22 and 26 the provisions of the Federal Youth Corrections Act, a wide act cutting across various statutes, would still control, but that as to those between 22 and 26, although the sentencing provisions of the Federal Youth Corrections Act were adopted, nevertheless none of the provisions in the Youth Corrections Act could be used if there was a mandatory penalty.

Now, trying to decide what Congress had in mind when a statute was passed is a difficult thing. The Government's argument seems to be based largely upon the fact that at the time the Youth Corrections Act was adopted there already was a provision in effect for probation. If that is true, Congress had no need even to put in Section 5010(a). If they didn't intend that this was a unified plan or scheme for handling youthful offenders they had no need to repeat it.

The provisions of the Youth Corrections Act hang together pretty well.

It seems to me that in view of the fact that the Youth Corrections Act cut across various other statutes—I have been trying to think of some mandatory provision where I might see the impact of it. The one I picked on doesn't work out.

Certainly, they had intended that a youthful offender could get more time than he could get under the statute which Congress had previously passed defining the crime, because he was being treated as a different kind of person—he was being treated not as a criminal who would serve some time and receive the treatment ordinarily afforded, but he was being treated as a youthful offender, a different type of category. If Congress had intended the Narcotics Control Act to mean that probation could not be given to a youthful offender, they could have made reference to the statute. They referred to various other statutes.

More than that, I feel serious doubt that Congress intended that the mandatory sentences provided by the Narcotics Control Act were to apply to youthful offenders.

So I am going to deny the Government's motion.

This may eventually create some hardship on these defendants. If the situation arises and I am reversed in this matter and you come back and I have to sentence them, I hope that the Government will still be of the position that Section 5010(b) is available and that the Attorney General could take into account what they have done on the probationary period that they have been serving and he well might provide some very short period of time to be served. On the other hand, if the defendants had not made good during this period when this appeal is being

processed, of course they could take an entirely different attitude.

I am not without doubt in this matter. There are certainly no guideposts to go by on the matter.

The motion in Case No. 27584 is denied.

United States Court of Appeals
FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Petitioner,

vs.

HONORABLE JAMES M. CARTER,

Respondent.

FILED

JUL 31 1959

PAUL P. O'BRIEN, CL

BRIEF FOR RESPONDENT

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No. 16522

IN THE
UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Petitioner,

vs.

HONORABLE JAMES M. CARTER,

Respondent.

BRIEF FOR RESPONDENT

JURISDICTIONAL STATEMENT

Respondent contends that petitioner should have sought the jurisdiction of this Court pursuant to the provisions of 18 U.S.C. 3731 rather than 28 U.S.C. 1651 for the reasons set forth infra, pp. 9-16.

ARGUMENT

I

THE TRIAL COURT HAD THE POWER UNDER THE YOUTH CORRECTIONS ACT OF 1950, TO SUSPEND DEFENDANTS' SENTENCES AND PLACE THEM ON PROBATION

The issue for the court to determine in this matter is whether or not the Narcotics Control Act of 1956 repealed the Youth Corrections Act of 1950. Respondent contends that the Narcotics Control Act of 1956 did not repeal the Youth Corrections Act of 1950, and Congress neither stated nor did they intend that such Youth Corrections Act be repealed by the Narcotics Control Act of 1956.

The Youth Corrections Act was under study for some ten years prior to its enactment in 1950. As stated in the House Report, the statute is designed to make available for the discretionary use of the federal judges a system for the sentencing and treatment of youth offenders that will promote the rehabilitation of those who show promise of becoming useful citizens and so will avoid the degenerative and needless transformation of many of those persons into habitual criminals. To that end, it provides for a system of analysis, treatment and release that will cure, rather than accentuate the anti-social tendencies that have lead to the commission of crime. This is done by permitting the substitution of correctional rehabilitation for retributive punishment. It marks the departure from the punitive idea of dealing with criminals and looks primarily to the objective idea

of rehabilitation. House Report No. 2979, 81st Congress, 2nd Session, Page 1.

In Cunningham v. United States, 256 F. 2d 467 (5th Cir. 1958), the defendant entered a plea of guilty to theft of a radio of a value of less than \$100.00. This was a misdemeanor charge with a maximum imprisonment of one year. The court, however, found that the defendant was a youth offender and committed him to the custody of the Attorney General pursuant to the provisions of the Youth Corrections Act. One year later, the defendant filed a writ of habeas corpus contending that, among other things, he could not be incarcerated for a period longer than the maximum one year provided on a misdemeanor charge. The 5th Circuit, speaking through Chief Judge Hutcheson, denied the writ of habeas corpus on the general grounds that the Youth Corrections Act controlled rather than the specific charge.

Commenting on the case the court quoted statements made by Chief Judge Phillips during hearings before a sub-committee of the Senate Judiciary Committee on a "Correctional System for Youth Offenders", 81st Congress, 1st Session, as follows:

"As stated in the House Report, the statute (Youth Corrections Act) is designed to make available for the discretionary use of federal judges the system for sentencing and treatment of youth offenders that would promote the rehabilitation of those who show promise of becoming useful citizens and so will avoid the degenerative and needless transformation of many of those persons into habitual criminals... It marks a departure from the punitive idea of

dealing with criminals and looks to the objective idea of rehabilitation." 156 F. 2d at p. 471.

It is clear that Congress intended to, and in fact did, establish a separate and distinct method and manner of treating those youth who were convicted of offenses between the ages of 18 and 22. In Cunningham v. U.S., supra, the court stated:

"As pointed out in the government's brief, the Youth Corrections Act applies to convicted persons under the age of 22 years at the time of the conviction and is designed to provide such persons with correctional treatment looking to their complete rehabilitation in lieu of punishment, that is, with preventative guidance and training, and all of its provisions are designed, enacted and enforced with that end in view. (emphasis added). 256 F. 2d at p. 471.

At this point the court's attention is respectfully directed to the government's argument that the Youth Corrections Act does not grant a trial court any new power to grant probation. (Petitioner's Brief, pp. 8-10). The invalidity of the proposition therein asserted is brought into sharp focus by a more extensive reading of the Senate Judiciary Committee's report. A material portion of that report reads as follows:

"Under its provisions, if the court finds that a youth offender does not need treatment, it may suspend the imposition or execution of sentence and place the youth offender on probation. Thus, the power of the court to grant probation is left undisturbed by the Bill.

If the court finds that a convicted person is a youth offender and the offense is punishable by imprisonment, it may, in lieu of the penalty of imprisonment otherwise provided by law, sentence the youth offender for treatment and supervision until discharged by the division, as provided in Section 5017 (c) of the Bill."

The Youth Corrections Act borrows from the Youth Authority statutes in California, Minnesota, Wisconsin, Massachusetts and Texas, and from a model act proposed by the American Law Institute in 1941. In a California case entitled In re Berrera, 23 Cal. 2d 206, at p. 213, the court in commenting on the reasonableness in the classification of those who may be sent to the Youth Authorities, stated:

"The great value in the treatment of youth offenders lies in its timeliness in striking at the roots of recidivism. Reaching the offender during his formative years, it can be an impressive bulwark against the confirmed criminality that defies rehabilitation, for it is characteristic of youth to be as responsive to good influence as it is susceptible to bad."

The California case and House Report indicate the purposes behind the legislature and the Congress in enacting the Youth Corrections Act. It is clear that they intended to and did in fact make a separate and distinct classification and a separate and distinct manner of handling youth offenders, if in the opinion of the judge sitting on the case, it was to the advantage and benefit of the youth to be given the advantage of measures available under the Youth Corrections Act and the Youth

Authorities Act.

Section 5010 (a) of Title 18 U.S.C., reads as follows:

"If the court is of the opinion that the youth offender does not need commitment, it may suspend the imposition or execution of sentence, and place the youth offender on probation."

This section is part of the Youth Corrections Act of 1930. In the case at bar, it is apparent that the government concedes that 18 U.S.C. § 5010 (b) (c) may be used by the court in imposing sentence, but that paragraph (a) of 18 U.S.C. 5010 is not applicable due to the enactment of the Narcotics Control Act of 1956. Respondent respectfully urges that there is no logic or persuasiveness in the government's position that some of the sentencing provisions of the Youth Corrections Act have been repealed by implication while others have not. Respondent contends that in enacting the Youth Corrections Act, additional powers were vested in the court in connection with the type of sentence that might be imposed. This argument is illustrated by the fact that the provisions of the Youth Corrections Act are different from the other provisions in the Code pertaining to punishment.

The Narcotics Control Act of 1956 is silent as to the effect it has upon the Youth Corrections Act. At a glance in the Code it will become evident that when Congress intends to effect some older legislation by new legislation, it makes reference to that fact in the enactment. By way of example, in 26 Sec. 7237 B (a) of the Internal Revenue Code, it is stated, among other things, that the imposition or execution of sentence shall not be

suspended (upon the conviction of designated offense) probation shall not be granted, Section 4202 of Title 18 U.S.C. shall not apply, and etc. Without quoting, but by reference only, 18 U.S.C. § 5026 again specifies the intent of Congress as to whether or not the new enactment shall affect related laws or activities. These are just a few of the examples of legislation or enactments by Congress, wherein they specifically state when other and older enactments shall be affected by new legislation. It is an old axiom of statutory construction that repeals by implication are not favored. Nowhere in the Narcotics Control Act of 1956 does there appear a statement directly or by inference, that Congress intended that the Youth Corrections Act be repealed in part or totally, by the Narcotics Control Act of 1956.

The court's attention is also directed to the fact that Congress, in enacting 18 U.S.C. 4209 (an Act authorizing the use of Youth Corrections Act for those from ages 22-26), expressly stated that that code section would not be applicable to any offense for which there was provided a mandatory penalty, but Congress was silent as to the effect that this section would have upon youths from the ages of 18-22.

By way of illustration of the additional features available under 18 U.S.C. 5010 (a), a youth of 19 convicted of a violation of the Dyer Act, can be granted probation or can be committed for any period that the court might determine up to a maximum of five years. The commitment would be under 18 U.S.C. 2312 and probation would be under 18 U.S.C. § 3651, et seq. This would be the situation prior to 1950. However, since 1950 the court has still another new and different method of sentencing a 19 year old youth convicted under the

Dyer Act. The new method is set forth in the Youth Corrections Act and authorizes the court to place the defendant on probation pursuant to the Youth Corrections Act or commit him pursuant to the same Act. 18 U.S.C. § 5010 (b), et seq. Once a defendant has been found by the court to be a youth offender within the meaning of the Act, then the Youth Corrections Act controls. In the hypothetical example, if the 19 year old defendant is placed on probation under the general probationary sections, and thereafter violates his probation, the court of necessity must impose sentence pursuant to 18 U.S.C. § 2312. However, if the court has held that the 19 year old is a youth offender, and places him on probation pursuant to the Youth Corrections Act, and he thereafter violates his probation, then the court may impose sentence only pursuant to the Youth Corrections Act and may not revert to 18 U.S.C. § 2312. Cunningham v. United States, supra.

Congress must have intended to create a new and different type of probationary sentence when it included same within the Youth Corrections Act, or the reference to probation in the same section would be superfluous. As further indication of congressional intent, the court's attention is respectfully directed to 18 U.S.C. 5023, which states:

"Nothing in this chapter shall limit or affect the power of any court to suspend the imposition or execution of any sentence and place the youth offender on probation or be construed in any wise to amend, repeal or affect the provisions of chapter 231 of this Title; (Probation)."

It would appear that this means that the court, under appropriate circumstances, could place a 19 year old defendant under probation pursuant to the general probationary sections or the Youth Corrections Act, which ever appeared to be more appropriate.

Congress could have specifically stated that the Youth Corrections Act was not subject to an offense where there was a mandatory penalty. This they have not done. Accordingly, it is respectfully submitted that Congress did not intend to, and in fact did not, repeal the effect and operation of the Youth Corrections Act in any manner by the enactment of the Narcotics Control Act of 1956.

II

THE PETITION FOR WRIT OF MANDAMUS SHOULD BE DENIED BECAUSE THE GOVERNMENT, BY FAILING TO APPEAL WITHIN THE STATUTORY THIRTY-DAY PERIOD, DID NOT AVAIL ITSELF OF THE REMEDY PROVIDED BY LAW AND THEREFORE HAS NO STANDING TO APPLY FOR AN EXTRAORDINARY WRIT.

Traditionally, the prosecution has never had the right to appeal in a criminal case. This is still the law in the federal courts today, except where it has been expressly modified by statute. Section 3731 of Title 18 of the United States Code, which was first enacted in 1907, and has been the law since that time with only minor changes, provides:

"Appeal by United States. An appeal may be taken by and on behalf of the United States from the district courts direct to the Supreme Court of the United States in all criminal cases in the following instances:

From a decision or judgment setting aside, or dismissing any indictment or information, or any count thereof, where such decision or judgment is based upon the invalidity or construction of the statute upon which the indictment or information is founded.

From a decision arresting a judgment of conviction for insufficiency of the indictment or information, where such decision is based upon the invalidity or construction of the statute upon which the indictment or information is founded.

From the decision or judgment sustaining a motion in bar, when the defendant has not been put in jeopardy.

An appeal may be taken by and on behalf of the United States from the district court to a court of appeals in all criminal cases, in the following instances:

From a decision or judgment setting aside, or dismissing any indictment or information, or any count thereof except where a direct appeal to the Supreme Court of the United States is provided by this section.

From a decision arresting a judgment of conviction except where a direct appeal to the Supreme Court of the United States is provided by this section.

The appeal in all such cases shall be taken within thirty days after the decision or judgment has been rendered and shall be diligently prosecuted.

Pending the prosecution and determination of the appeal in the foregoing instances, the defendant shall be admitted to bail on his own recognizance.

If an appeal shall be taken, pursuant to this section, to the Supreme Court of the United States which, in the opinion of that Court, should have been taken to a court of appeals, the Supreme Court shall remand the case to the court of appeals, which shall then have jurisdiction to hear and determine the same as if the appeal had been taken to that court in the first instance.

If an appeal shall be taken, pursuant to this section, to any court of appeals which, in the opinion of such court, should have been taken directly to the Supreme Court of the United States, such court shall certify the case to the Supreme Court of the United States, which shall thereupon have jurisdiction to hear and determine the case to the same extent as if an appeal had been taken directly to that Court.

In the case at bar, the trial court granted defendant Feaux's motion and ordered that her sentence be suspended and that she be placed on probation. That such an order is appealable by the government because it has the effect of arresting the judgment of conviction, is established by the decisions of the lower federal courts and of the Supreme Court.

In United States vs. Albrecht, 25 F. 2d 93 (7th Cir. 1928), the trial court made an order placing the defendants on probation after they had commenced serving their sentences. The government sued out a writ of error to the court of appeals. That court held that it had jurisdiction to entertain a writ of error at the

instance of the United States government in such a case. The same result was reached in United States v. Murrey, 19 F. 2d 826 (5th Cir. 1927), aff'd 275 U.S. 347 (1928).

It should be pointed out that at the time the Albrecht case was heard, the phrase "writ of error" was used in place of its synonym, "appeal". The change in terminology was effected by Sections 861(a) and 861(b) of Title 28, U. S. C.

These sections were omitted from the 1948 revision of the U. S. C. , undoubtedly because the word "appeal" had come to be used in all instances instead of the now outmoded phrase, "writ of error". However, the substance of Section 861(b) was allowed to remain on the books and reads as follows:

"All acts of Congress referring to 'writs of error' shall be construed as amended to the extent necessary to substitute 'appeal' for 'writ of error.' "

Act of June 25, 1948, c. 646, Sec. 23;
Stat. 990, Public Laws 773, effective
September 1, 1948.

Even so, as late as 1949, a federal court found it necessary to point out that appeal has the same force and effect as its predecessor, the writ of error. Alexander v. United States, 173 F. 2d 865 (9th Cir. 1949).

Thus, it is clear today that the United States government has a right to appeal when it is urged that the trial court lacked jurisdiction to enter an order modifying a defendant's sentence or directing that he be placed on probation.

There are sound reasons why the government's petition for mandamus should be denied. The authorities abound with the statement that mandamus shall not be used as a substitute for appeal. Ex Parte Riddle, 255 U.S. 450 (1921). Matter of Tiffany, 252 U.S. 32 (1920). It follows that when the United States had the statutory right to appeal, and failed to utilize it, they should not now be permitted to obtain a review of the decision of the lower court by seeking a writ of mandamus.

In Ex Parte Riddle, Supra, on petitioner's motion to correct the record, the lower court had ruled that the record need not be corrected to show that, as the result of an agreement between the accused and the District Attorney, the case had been tried before a jury of eleven. Petitioner sought a writ of mandate ordering the trial judge to correct the record. In denying his petition, the court held that inasmuch as the petitioner could have saved the point by exception at the trial or by a bill of exceptions to the denial of his subsequent motion setting forth whatever facts or offers of proof were material, and then brought a writ of error. The court went on to say, "In such cases, mandamus will not lie, at least it is not to be used when another statutory remedy has been provided for reviewing the action below. 255 U.S. at 451 (emphasis added).

Further support for this proposition is found in a case cited by the United States in the case at bar. In Roche v. Evaporated Milk Ass'n., 319 U.S. 21 (1943), the court said, "Appellate courts are reluctant to interfere with the decision of a lower court on jurisdictional questions which it was competent to decide and which are reviewable in the regular course of appeal." 319 U.S. at 26. It should be pointed out that the United

States specifically contends the trial court lacked jurisdiction. (Petitioner's Brief, P. 38).

As has been pointed out in the case at bar, the United States had an opportunity to appeal the order of the trial court. The authorities support the proposition that the orderly administration of justice demands that a party utilize the remedies provided by law, in the order therein prescribed. Myers v. Bethlehem Shipbuilding Corp., 303 U.S. 41 (1938). Instead of appealing when it should have done so, the United States allowed the time for appeal to expire. It is respectfully submitted that by doing so they are not now entitled to a writ of mandate. The policy behind the rule in the field of administrative law that requires a party to exhaust all his administrative remedies before seeking the assistance of the courts, applies with equal force to a matter wholly within the judiciary. When a judgment has been entered, no writ of mandate should issue until the matter has been argued on appeal, absent a showing of urgent circumstances. United States ex rel Conner v. Dist. of Columbia, 61 F. 2d 1015 (D.C. Cir. 1932). In many such instances the appellate court will reverse, thus eliminating the reason for seeking the extraordinary writ, and thereby avoiding the necessity of the higher court having to exercise its discretion. In the instances where the appellate court affirms, the court to which the petition for the writ is directed will have benefit of that opinion and will thereby be better informed as regarding the problem before it.

III

BECAUSE MANDAMUS ISSUES ONLY IN
THE SOUND DISCRETION OF THE COURT,
THE GOVERNMENT'S PETITION SHOULD
BE DENIED UNLESS INJUSTICE OR
GREAT INJURY WOULD OTHERWISE
RESULT.

Without exception, the authorities hold that the writ of mandamus should be sparingly granted and only when in the sound discretion of the court it is absolutely necessary in order to prevent injustice or great injury. Ex Parte Republic of Peru, 318 U.S. 578 (1942).

If there is a doubt regarding the necessity to issue the writ, it should not be issued. Laycock v. Hidalgo County Water Control & Improvement Dist. No. 12, 142 F. 2d 789 (5th Cir. 1944).

The application of these rules of law to the facts in the case at bar leads to the irrefutable conclusion that it is unnecessary for mandamus to issue. Over one year has elapsed since Robert Emil Austin was placed on probation and nearly four months has elapsed since defendant Feaux was placed on probation pursuant to the Youth Corrections Act, 18 U.S.C. § 5010 (a). During that time, both defendants have altered their attitudes toward life and society and have adopted a healthy outlook toward the future. Both continue making satisfactory adjustments under probationary supervision.

Respondent therefore respectfully urges that, because no injustice or injury will result if the order of the trial court is allowed to stand, and because the

United States failed to exercise its right to appeal or take any action during a reasonable period the government's petition for writ of mandate should be denied.

CONCLUSION

As the Narcotics Control Act of 1956 has not repealed the Youth Corrections Act, Respondent urges that the petition for Writ of Mandamus be denied.

Respectfully submitted,

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No. 16528. ✓

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

WILLIAM LAIRD MCGOWAN,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLEE'S BRIEF.

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No. 16528.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

WILLIAM LAIRD MCGOWAN,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLEE'S BRIEF.

Statement of Jurisdiction.

This is an appeal from a judgment of the United States District Court for the Southern District of California, the Honorable Ben Harrison presiding, adjudging appellant guilty of violating 21 U. S. C., Section 174. This judgment entered on July 7, 1958 [C. 21-22]¹ committed appellant to the custody of the Attorney General for concurrent sentences of five years each on Counts One and Two of the indictment [C. 1-2]. Jurisdiction of the District Court was founded upon 18 U. S. C., Section 3231.

¹The abbreviation "C." hereafter refers to the "Clerk's Transcript of Record."

Jurisdiction of this Honorable Court to hear this cause may be found in Sections 1291 and 1294(1) of Title 28, U. S. C., and Rules 37 and 39 of the Federal Rules of Criminal Procedure.

Statement of the Case.

Count One of the indictment charged appellant with unlawful receipt, concealment, and transportation of narcotics, whereas Count Two of the indictment charged appellant with unlawful sale of narcotics. At the trial the allegations of the indictment were established primarily by the government's witness, Richard L. Munson, the individual to whom appellant sold the narcotics in question. After the direct examination [R. 7-25] of Munson, appellant subjected the witness to a lengthy cross-examination [R. 25-63].² At the end of the government's case in chief there was no motion for judgment of acquittal [R. 83]; instead, appellant took the stand [R. 85-111]. Appellant's evidence controverted Munson's testimony that a sale of heroin did in fact take place. Appellant testified that he had discussed selling heroin to Munson [R. 91, lines 5-7], but solely for the purpose of taking any money Munson might give him [*e.g.*, R. 93, lines 1 and 2; 105, line 5]. The jury subsequently resolved any issue of credibility between the two adversely to appellant [R. 151].

²The abbreviation "R." hereafter refers to the "Reporter's Transcript."

ARGUMENT.

I.

The Trial Court Did Not Err in Limiting the Cross-Examination of the Government's Witness.

A. The Trial Court Did Not Abuse Its Discretion.

One of the principles of *Alford v. United States*, 282 U. S. 687 (1930), the case upon which appellant principally relies, is that "the extent of cross-examination with respect to an appropriate subject of inquiry within the sound discretion of the trial court. It may exercise a reasonable judgment in determining when the subject is exhausted" at page 694. In the instant case, appellee submits that the subject of the witness Munson's remote arrest for possession of marihuana was exhausted and that the trial court exercised a sound discretion in precluding further inquiry of the matter. Appellant established on cross-examination that Munson had been arrested for possession of marihuana on October 14, 1954 [R. 30, lines 8-10]. However, Munson and appellant did not have discussions about heroin until the latter part of 1956 [R. 8, lines 23-25; R. 9]; moreover, the offense for which appellant was indicted did not occur until November 15, 1957 [C. 1-2]. Now, it is true, though extremely unlikely, that Munson's arrest for possession of marihuana on October 14, 1954, may have, as appellant suggests, biased and prejudiced him against appellant. It is possible, although improbable, that this arrest of three years prior to the incriminating event of November 15, 1957, may have motivated and influenced Munson out of fear of police

reprisal to testify more favorably to the prosecution than the facts warranted. However, appellant was given extremely wide latitude in pursuing this unlikely and collateral tack in his examination of the witness Munson *before* the ruling complained of occurred [R. 29, lines 14-25; R. 30; R. 31, lines 1-6]:

“And what was your reason for going to work with the Government? A. My reason?

Q. Yes. A. Call it civic duty.

Q. You were following a civic duty? A. I don't like heroin or anything that it stands for or anyone who uses it.

Q. Do you like marijuana? A. No.

Q. Have you ever had any possession of marijuana? A. No.

The Court: I do not think that is proper.

Mr. Bradley: In view of his statement that he doesn't like heroin I thought certainly I ought to know if he is interested in marijuana.

The Court: We are only interested in heroin in this case.

By Mr. Bradley:

Q. As a matter of fact, Mr. Munson, were you arrested and in possession of marijuana, isn't that right? A. October 14, 1954.

Q. And as a result of this arrest that is why you went to work for the Government, isn't that true? A. That is not true, and I was arrested for suspicion of possession.

Q. There was marijuana there, wasn't there? A. Yes.

Q. That was in your home? A. No.

Q. Your apartment? A. No.

Q. Somebody else's place? A. Yes.

The Court: Now, counsel, I don't think that is a proper line of inquiry. If you have any record of a conviction for a felony, that is one thing.

Mr. Bradley: Your Honor, I submit it goes to the bias and prejudice of the witness. If he has a motive in working for the Government as an informer, certainly we are entitled to show that as distinguished from his testimony that he went there out of civic duty.

The Court: I have ruled, counsel."

It can be seen from the foregoing that appellant was not precluded from examining Munson on subsequent arrests, if any, or convictions, if any. The trial court had previously indicated it would indulge inquiries of this nature [R. 25, lines 12-25; R. 26, lines 1-20]. It is therefore apparent that in restricting appellant's cross-examination on this single unrelated arrest that the trial court was exercising a reasonable discretion. Moreover, it was duty bound to do so because "[t]here is a duty to protect [a witness] from questions which go beyond the bounds of proper cross-examination merely to harass, annoy or humiliate him. (*Alford v. United States, op. cit.* at p. 694.) Appellee submits that further delving into the details of the arrest of October 14, 1954, would have been improper because it would have served merely to harass or humiliate the witness.

B. Appellant Has No Cause to Complain Because He Did Not Abide by the Court's Ruling.

Alford v. United States, op. cit., and *District of Columbia v. Clawans*, 300 U. S. 617, 630 (1936), as well as the other cases upon which appellant relies are all distinguishable from the instant case. Those cases all stand for the proposition that cross-examination of the prosecution's witnesses on subjects going to credibility must not be summarily curtailed. In all of the cases cited by appellant the court ruled *in limine* that the prosecution's witnesses could not be interrogated on certain subjects. However, from the quoted portion of the transcript above, we have seen that appellant's cross-examination was not throttled at the mention of the subject matter. Moreover, here appellant has no cause to complain because, not only was he afforded reasonable scope or latitude in his cross-examination of Munson (*Cf. United States v. Migliorino*, 238 F. 2d 7, 11 (3rd Cir., 1956)), he ignored the court's ruling and pursued the line of inquiry notwithstanding. The record on this point shows [R. 31; R. 32, line 1-7]:

"Mr. Bradley: Your Honor, I submit it goes to the bias and prejudice of the witness. If he has a motive in working for the Government as an informer, certainly we are entitled to show that as distinguished from his testimony that he went there out of civic duty.

The Court: I have ruled, counsel.

By Mr. Bradley:

Q. Well, as a result of going to work for the Government as an informer, were you promised that you wouldn't be prosecuted on that particular charge? A. No, I wasn't.

Q. Was it discussed at all? A. No, sir. I didn't go to work for the Government until three years ago.

Q. And this particular event occurred four years ago? A. Almost four years ago.

Q. Almost? A. Yes.

Q. On how many occasions have you acted as an informer for the Government? A. Do I have to answer that, sir?

The Court: I think you can answer that.

The Witness: Three or four.

By Mr. Bradley:

Q. Does that include the testimony that you have given here in regard to your connection with Mr. McGowan? A. Yes, it does.

Q. And the performance of those services was in connection with heroin? A. Yes, sir."

Appellant then abandoned the subject and went on to other matters.

The government submits that the instant situation is well within the case of *Chevillard v. United States*, 155 F. 2d 929, 930 (9th Cir., 1946). There, the court affirmed the trial court's ruling that one B——, a government witness who had pleaded guilty to the crime with which Chevillard was charged need not answer the question "do you know how long you could be sent to jail." This court there held that the trial court did not abuse its discretion in limiting this cross-examination of B——. In *Chevillard* the witness' hopes for leniency at time of sentence, it would seem, could not fail to affect his testimony. Yet here Munson was not a co-defendant or co-conspirator of ap-

pellant. However, in the instant case, the possibility of Munson's bias or hope of leniency were thoroughly explored by appellant, *supra*.

Conclusion.

In conclusion, appellee submits to this Honorable Court:

1. That the trial court did not abuse its discretion when it reasonably limited appellant's cross-examination of the government's witness when it appeared that the questions were designed to humiliate or annoy him rather than to test his credibility, and
2. That in any event appellant has no cause to complain since he continued to probe the subject despite the court's ruling.

Hence, for either or both these reasons, the judgment appealed from below should be affirmed.

Respectfully submitted,

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